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HOUSING FINANCE REFORM: FUNDAMENTALS OF A FUNCTIONING PRIVATE LABEL MORTGAGE-BACKED SECURITIES MARKET

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXPLORING THE STATUS OF THE PRIVATE LABEL MORTGAGE BACKED SECURITIES MARKET SINCE THE FINANCIAL CRISIS OF 2008

OCTOBER 1, 2013

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C O N T E N T S

TUESDAY, OCTOBER 1, 2013

HOUSING FINANCE REFORM: FUNDAMENTALS OF A FUNCTIONING PRIVATE LABEL MORTGAGE–BACKED SECURITIES MARKET

TUESDAY, OCTOBER 1, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good morning. I call this hearing to order.

Today we meet to examine the private label mortgage-backed securities market, the barriers that exist in the current market that prevent private capital from reentering, and how this market fits into any housing finance reform effort.

At the height of the housing boom, private capital represented more than 50 percent of the mortgage market. Today it is closer to 5 percent. While Government-backed loans represent 95 percent of the current market, the volume of Government-backed loans has not changed that much. What has changed is a major reduction in volume by the private market.

I think we can all agree that the private market should play a more substantial role in our housing finance system than it is currently. That said, we must be certain that any new system we design will actually attract private capital.

For securitization to work well, especially in the PLS market, the underlying loans must be well underwritten and there should be greater transparency. The Wall Street Reform Act includes key reforms, such as QM, QRM, and disclosure requirements, that will help prevent another crisis caused by high-risk loans that were bundled and sold to investors. Final rules, along with higher guarantee fees, will provide strong incentives for the private market to return.

Additionally, the recent crisis showed us weaknesses in the current loss mitigation and foreclosure process. We should look at ways to eliminate barriers to reasonable loss mitigation efforts that are ultimately in the borrowers' and investors' interest.

With any reform, we must create the necessary conditions to bring private investors into this market while at the same time sustaining structures like the To-Be-Announced market. The TBA market is a key component to ensure access, affordability, and liquidity for borrowers and investors, and it allows for the existence of the 30-year mortgage, important to millions of Americans. We will have future hearings on these issues, but if private capital were to take any first-loss position ahead of a future Government-guaranteed security, we must make sure it is compatible with the TBA market.

These are extremely complex issues, and there are no easy answers. That is why we are exploring the role of private capital early in our series of in-depth housing finance reform hearings this fall. We must get this part right. As we have learned, private capital may not always participate in all segments of the housing finance market under all economic conditions. Any steps this Committee takes to refocus and redefine the Government's role and improve the securitization process in the housing finance system must foster stable private capital flows, provide access to smaller lenders, and not price the middle class out of affordable mortgage products.

Clearly, we have our work cut out for us, and I look forward to this morning's discussion.

Senator Crapo, do you have any opening statement?

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Yes, and thank you, Mr. Chairman.

We have just passed the 5-year anniversary of the conservatorship of Fannie Mae and Freddie Mac, and now the Federal Housing Administration has announced that it will require a nearly $2 billion draw from the Treasury, almost double the amount that was projected in the President's 2014 budget. This announcement highlights the reality that we must act now to reform the Government-sponsored enterprises and the larger housing market.

As we noted during our last hearing, the Committee will examine individual components of our housing finance system through a series of hearings intended to produce bipartisan agreement by the end of the year.

Today we take a more in-depth look at our first issue as we hear from witnesses on the private label securitization market. This being one of the first topics we discuss should indicate just how important a vibrant, well-functioning private mortgage-backed securities market is to our housing finance system.

Unfortunately, today's private label market is a tiny fraction of what it was prior to the financial crisis. The Federal Housing and Finance Authority's latest conservators' report showed that the Federal Government, through Fannie, Freddie, and Ginnie Mae, backed nearly 100 percent of the mortgage-backed securities that were issued in 2012 and the first quarter of 2013.

It is clear that private capital is on the sidelines and that the Government needs to reduce its footprint. Our goal should be to identify what particular challenges face the private mortgage-backed securities market, be they regulatory, legal, or structural hurdles. To that end, this hearing gives us an opportunity to learn why private capital is sidelined in our mortgage market and what needs to be done to bring the mix of the private sector and the Government into an appropriate balance.

We have seen some experimentation in the private label market this year, but it is too early to tell what momentum will flow from those deals. I welcome the recommendations our witnesses have to bring back private capital into this critical segment of our economy while protecting the U.S. taxpayer from a future bailout scenario.

In particular, I am interested to hear your views on whether the private label inactivity is rooted in a lack of confidence in the transparency, in risk mitigation, and alignment of interests in the mortgage chain. Could a lack of confidence in the private label space drive investors to overvalue the Federal support afforded through GSEs by comparison? What commonsense reforms can we put in place to restore investor confidence?

I have heard that a lack of standardized documentation for securities issuance and process for the review of mortgages within securitized pools is a reason why investors are hesitant to reenter the private label market. What reforms are necessary to achieve adequate uniformity? What kind of progress has there been for private label market participants to come to administration on standards for issuance of review of mortgages, including representations and warranties or other issues?

I have heard that the question of eminent domain has created a lot of uncertainty with respect to investors' willingness to enter the private label market. What are the impacts that you see in the private label space from these eminent domain policies? I would also like to hear our witnesses' views on what they anticipate the private label market will look like in the future.

I hope that as we proceed with these reforms we will build upon the momentum that has recently been generated on both sides of the Capitol and the White House.

Time is of essence, and the GSEs continue in an unsustainable conservatorship, and the FHA's financial condition continues to deteriorate. Chairman Johnson and I moved the FHA solvency bill out of Committee earlier this year, and it is time for us to engage on broader reforms. And I want to take this opportunity to thank the Chairman for his eager willingness to work with us to build a bipartisan solution and to move forward expeditiously.

I remain strongly committed to working with the Chairman and all of my colleagues toward a bipartisan solution and a process to fix these difficulties soon.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who would like to give brief opening statements?

[No response.]

Chairman JOHNSON. I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and other materials. Before we begin, I would like to introduce our witnesses.

Mr. Martin Hughes is the chief executive officer and member of the board of directors of Redwood Trust, Inc.

Mr. John Gidman is an executive vice president and chief information officer at Loomis, Sayles & Company. Mr. Gidman is also president of the Association of Institutional Investors.

And, finally, Mr. Adam Levitin is a professor at the Georgetown University Law Center and is the Chair of the Mortgage Committee of the Consumer Financial Protection Bureau's Consumer Advisory Board.

Mr. Hughes, you may proceed.

STATEMENT OF MARTIN S. HUGHES, CHIEF EXECUTIVE OFFICER, REDWOOD TRUST, INC.

Mr. HUGHES. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. I appreciate the opportunity to be here today. My testimony will focus on the current state of the private MBS market and actions that can be taken to fully accelerate its return.

Redwood currently operates a prime jumbo loan conduit where we acquire mortgages from originators for pooling and sale primarily through our Sequoia private securitization platform.

In addition, we recently received our seller/servicer licenses from Fannie Mae and Freddie Mac. This will enable us to work with the enterprises to find ways for Redwood to invest in the first loss credit risk and the loans we sell to the enterprises, thereby putting the enterprises in a second-loss credit position.

The private sector of the U.S. secondary mortgage market consists of portfolio lenders who are primarily banks and private label issuers such as Redwood, although banks may be issuers as well. I firmly believe over the long term private label mortgage securitization will remain a very necessary and efficient form of mortgage financing.

Many have speculated on why the private label MBS market is not fully flourishing today. There is no single answer to this question, and there are a variety of factors that must be considered. Some of these factors will be self-correcting over time while others will require structural or legislative change. I have specific changes to recommend, but I would first like to offer the following broad observations that explain the current state of the private market.

First, as a result of the increase in the conforming loan limit, there are simply fewer jumbo loans being created today.

Second, the enterprises have had a significant pricing advantage over the private MBS market. This advantage has been reduced somewhat as guarantee fees have been increased over the past 2 years.

Third, and importantly, major banks, which were significant issuers of private MBS, have made a business decision to hold significantly more jumbo loans in portfolio rather than securitize them or sell the loans.

Fourth, AAA investors still have questions of confidence in whether their rights and interests in the securities they purchase would be respected and, consequently, that their investments would be safe and secure.

And, fifth, it is a Catch-22, and that is, in order to for the private label market to attract more investors, the asset class needs to be larger and more liquid. On the other hand, the private lable MBS asset class cannot achieve a larger liquid critical mass as long as it is too small for investors to justify allocating analytical and monetary resources to private label MBS.

These issues are solvable. Market and Government policy makers can work together to fully restore the private label MBS market. The key to our success will require a primary focus on the needs of institutional investors that buy the senior classes of mortgage-backed securities. Simply put, these investors have the money, and without their participation, there is no market.

Fortunately, addressing investors' concerns is not a complicated task. It requires better risk mitigation, transparency, and alignment of interests throughout the mortgage chain. We can achieve this by correcting the structural deficiencies and conflicts in securitization that became apparent in the wake of the financial crisis.

My written testimony goes into more detail about the following recommendations: We must establish best practices for representations and warranties and other key securitization terms. We must establish binding arbitration as the minimum standard for dispute resolution of representation and warranty breaches. We must require that securitization trusts create the position of a credit risk manager. We must address servicer responsibilities and conflict of interest issues. We must also control the systematic and loan-level risk of second-lien mortgages by giving first-lien holders the ability to require their consent to a second lien if the combined loan-to-value with all other liens will exceed 80 percent. And we must reduce the Government's participation in the mortgage market by reducing the enterprises' conforming loan limits on a safe and measured pace.

In conclusion, the U.S. mortgage market is a complex system with many parts and key participants. Each plays a supportive role in creating a highly liquid and efficient market. The private label MBS market will once again assume a major role, alongside the Government-supported sector, as the issues I have discussed begin to get resolved.

Thank you, and thank you for being here on this important day.

Chairman JOHNSON. Thank you.

Mr. Gidman, please proceed.

STATEMENT OF JOHN GIDMAN, PRESIDENT, ASSOCIATION OF INSTITUTIONAL INVESTORS

Mr. GIDMAN. Thank you. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for inviting me here today to testify regarding the fundamentals of a functioning private label mortgage-backed securities market.

My name is John Gidman. I am an executive vice president of Loomis, Sayles & Company in Boston, Massachusetts, but I am testifying here today in my role as president of the Association of Institutional Investors. The association is an organization of some of the oldest and largest institutional investment advisers in the United States. All our firms have a fiduciary duty to put our clients' interests first. Put simply, it is not our money.

Collectively, the association's members manage investments for more than 80,000 pension plans, 401(k)s, and mutual funds on behalf of more than 100 million American workers and retirees. Our clients include companies and labor unions, public and private pension plans, mutual funds, and families who rely on us to prudently manage their investments, in part due to the fiduciary duty we owe these organizations and families.

We recognize the vital role housing finance markets play in our society. These markets have traditionally provided generations of families pathways to gain home ownership. For decades, this defined the American Dream. Much of this mortgage financing has ultimately been provided by our clients who relied on the strength and depth of these markets to provide them the income they needed for retirement.

The PLS market has improved since the bottom of the financial crisis. However, the absolute volume remains a very small fraction of what it was before the crisis. And there is a vast gulf between the types of loans funded by the private label securitization market and those that are supported by the GSEs.

Typically now PLS loans average approximately 66 percent loan-to-value and a 760 FICO score, with very few second liens and no mortgage insurance. Borrowers have 20 to 50 percent equity in the property, and the average home price of these mortgages is over $1 million. These high prices, combined with large downpayments and very high credit quality, have led to a situation where the current PLS standards cannot be used to finance mortgages for the majority of Americans.

Institutional investors want to be able to invest in the full range of the mortgage sector on behalf of our clients. There is pent-up demand. However, as fiduciaries, we cannot increase our conviction in this market without meaningful structural reform. Therefore, we fully support Congress' efforts to reform the mortgage market. The recently introduced Housing Finance Reform and Taxpayer Protection Act has moved the debate in the right direction. The bill's risk-sharing mechanisms offer a promising solution that we believe could work if investors' concerns are addressed.

The legislation also provides helpful language regarding issues like standardization of documentation and enforcing representations and warranties. The bill, however, does not address three fundamental investor concerns which we would like to touch on today.

First, any mortgage market reform legislation should include, in our view, trustee fiduciary duties to oversee the maintenance of trusts and enforce put-back obligations for faulty loans with regulatory oversight and private causes of action for breaches. Situations like last year's AG mortgage servicing settlement, where trustees and servicers were able to sacrifice the assets of trust investors' pension plans in favor of their bottom line, underscore the need for these duties.

Second, we believe the ability-to-repay rulemaking will lead institutional investors to avoid the PLS market. We agree with holding originators accountable for predatory lending by allowing defaulting borrowers to sue lenders for irresponsible lending. However, the rule includes assignee liability which we believe allows the borrower to sue any subsequent buyer of the loan, even if they were not the lender who made the bad loan in the first place.

And, third, certain jurisdictions are considering implementing a program designed and aggressively marketed by a private fund. Under the program, the city would rent out its local eminent domain power to seize performing mortgages, held in interstate trusts, in order to restructure the mortgages at a profit for the fund's investors. If mortgage market reform does not address this scheme and eminent domain is used, we will have to weigh the possibility that all future mortgage contracts might not be upheld, and our clients could lose their value in those investments.

As the Committee continues to consider housing finance reform, we hope these perspectives support your efforts. Each suggestion is intended to help rekindle a vibrant secondary mortgage market, accomplish your goal of reducing the Government footprint, and avoid adverse consequences that will ultimately affect the millions of Americans who rely on these markets to save for their families' needs.

Thank you for your time today, and I look forward to answering your questions.

Chairman JOHNSON. Thank you.

Professor Levitin, you may proceed.

STATEMENT OF ADAM J. LEVITIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. LEVITIN. Good morning, Mr. Chairman Johnson, Ranking Member Crapo, and Members of the Committee. Thank you for inviting me to testify this morning, and thank you for continuing today with your important work on housing finance reform.

Housing finance is a huge market, some $11 trillion of debt outstanding, and it is vitally important to our economy as it affects things ranging from the home-building and home-furnishing industries to the value of what is the single largest asset for many families.

There is widespread recognition that reforms are needed in the housing finance market, and yet this is also an area in which reforms must proceed with caution as there are potentially serious consequences from getting it wrong. Rule 1 in housing finance reform should be, "Do no harm."

Now, there is reasonable disagreement on the details of reform, but the overwhelming evidence makes clear that we cannot rely on private label mortgage-backed securities, or PLS, to be the backbone of the housing finance system.

PLS are mortgage-backed securities that lack any sort of Government or GSE guarantee whatsoever. I want to make clear that when I refer to PLS, I am not talking about what S.1217 envisions for the FMIC guaranteeing with a 10-percent first-loss piece.

Historically, prior to 2004, PLS were a small part of the housing finance market, never accounting for more than 15 percent of the financing in the market. Between 2004 and 2007, however, PLS provided the high octane rocket fuel that drove housing prices into the stratosphere before the bumpy reentry that we all know all too well.

The PLS market has not rebounded. Indeed, it remains basically dead. There have only been around 17,000 mortgages that have been financed by the PLS market since 2008. That is fewer than the number of mortgages financed in the District of Columbia last year. And as Mr. Gidman laid out, these have been ultra, ultra prime mortgages.

There are many reasons why the PLS market has not rebounded, but key among them is it has not solved many of its internal market structure and incentive problems relating to the roles of trustees, servicers, and enforcement of representations and warranties. And there are reforms, as I discuss in my written testimony, that can be undertaken to improve PLS.

Ultimately, though, even an improved PLS market cannot change the fundamental math. By a very generous estimate, capital markets will be able to support no more than around $500 billion annually in mortgage credit risk. The U.S. housing finance market needs anywhere between $1.5 trillion and $4 trillion in annual financing, depending on market conditions.

Capital markets are insufficient to support the amount of credit risk needed to sustain the U.S. housing market. They can plan an ancillary role, but they are simply incapable of providing the foundation for the market.

Instead, a discussion of how to rebuild the housing finance system needs to be based around some form of a hybrid public–private structure with first-loss private capital sitting in front of a public guarantee.

A rebuilt housing finance system also needs to have the capacity for the Federal Government to step into the breach as needed during countercyclical events when private capital flees from the market.

And I would say there are really two salient lessons that we should have in mind from the recent financial crisis and how the housing market responded. The first is that when things started getting hairy in 2007 and 2008, private capital fled. But for the continued operations of the GSEs and FHA, the market would have entirely collapsed, and we would have been in another Great Depression.

But there was a consequence from the Federal Government stepping into the breach, and that is the second lesson: that the Government is on the hook for the losses in the system, and herein lies the challenge, I think. There is a fine line to walk between needing to preserve the stability of the housing finance market, particularly in times of economic crisis, and that is something that only a Federal guarantee can really do credibly; but also wanting to avoid the problems that come from public allocation of capital, such as politicized underwriting and the socialization of losses.

There are reasonable disagreements on how exactly to craft a solution to that, but I think it is going to have to take the form of some sort of hybrid public–private housing finance system. S.1217, the Corker-Warner bill, represents one possible template for doing so. Another possible template would be based on amending the charters for the existing GSEs and, among other things, requiring first-loss private capital on their MBS.

I believe there is more work to be done on these proposals, but bills like S.1217 are moving in the right direction. I am happy to discuss the technical details of S.1217 and other proposals, but I would emphasize that it is important not to lose sight of the forest for the trees in housing finance reform. The structure of a housing finance market is a means toward housing policy, not an end in and of itself, and, therefore, it is critical that any redesigned system be charged, I think explicitly, with preserving the widespread availability of the 30-year fixed-rate mortgage, the continued existence of a TBA market that allows for interest rate risk hedging and preclosing rate locks, as well as fair access and affordable housing and multifamily housing options.

I look forward to your questions.

Chairman JOHNSON. Thank you all very much for your testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Professor Levitin, what is the one key lesson the market learned about MBS investing after the financial crisis?

Mr. LEVITIN. I think the key lesson we learned is just how flighty private capital can be. The housing finance market needs constant reinvestment flows in order to sustain housing prices in the market. And what we learned from 2008 is that private capital will flee to safe assets in times of economic uncertainty, and this can actually have the effect of worsening an economic downturn because of the critical role of the housing market in the economy.

So I think the critical lesson we have learned is that we need to have some sort of Government and I think explicit Government role in the market for market stability purposes.

Chairman JOHNSON. Mr. Hughes, would standardization of private label MBS terms and documentation be an effective means of bringing private capital back into the market?

Mr. HUGHES. Yes. I would think—you know, there has been some standardization so far. I think there needs to be farther to go both on representations and warranties, both the definition of what those representations are, and then, more importantly, what the enforcement mechanisms are.

But I think there is a number that I lay out in my written testimony where I think the securitization terms, reps, warranties, can be improved and standardized.

Chairman JOHNSON. Mr. Gidman, in MBS pools with troubled loans, how do we address conflicts or barriers affecting private label MBS mortgage trustees and servicers?

Mr. GIDMAN. I think in terms of lessons learned from the financial crisis, many of those have been talked about today by other witnesses and alluded to in your opening statement and in others. The central issue for us in GSE reform going forward is really the role of the trustee and also the role of the servicer. For us, we believe that transparency in their activities and alignment of interests, specifically with an enumerated fiduciary duty, is a critical gap in the existing PLS market that has not yet been fixed, and without it being fixed going forward, it is hard to see how investors could come back into the PLS market in a meaningful way.

Chairman JOHNSON. Professor Levitin, is there enough stable private capital to stand in front of a Government guarantee for MBS in good and bad economic times? Is this compatible with the TBA market?

Mr. LEVITIN. Well, the answer really depends on how much private capital you want, first-loss private capital you want. If you are looking for 10-percent first-loss private capital, such as envisioned in the Corker-Warner bill, I think there is a bit of a question about that, whether there is enough private capital, and part of the answer depends on how you are going to define capital. Does it have to be real capital in terms of, you know, dollars or Treasury securities in an escrow account backing something up? That I am skeptical that there is enough if we define capital in very strict terms.

If we define capital more loosely, allowing derivatives to be counted as capital, for example, then, yes, there would be, but there are risks because that is not the same quality of capital if we do that.

As far as a TBA market goes, the critical thing for having a TBA market is having interchangeable liquid securities. A TBA market is a market in forward contracts on mortgage-backed securities. So parties are buying and selling these securities before they come into existence.

If there is geographic information about the loans in an MBS pool, it is not possible to have a TBA market, and this means there is a real conflict between private label securities which do not have a TBA market and actually having a TBA market, because private label securities include information about geographic—about the geography of the loans in the pool because investors know that affects credit risk. But when you have credit risk in the equation, you cannot have a TBA market.

Chairman JOHNSON. Mr. Gidman, the GSEs have started a credit risk sharing program for their mortgage pools. What is attractive and unattractive to private investors in these deals?

Mr. GIDMAN. We think generally the approach that has been advocated in the recent housing reform package that has been drafted and circulated to the members and in the industry is a promising approach. Referencing specifically, I think, the STACR deal that recently came out, we found that to be promising in many ways structurally. The sole deficiency that prevented firms like mine from taking a substantial position really related to the absence of a rating because our investment guidelines require that. But generally the structure of the approach we think is attractive and interesting and merits further development.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

Mr. Hughes, I noted in my opening statement that it is time for the Government and, thus, the U.S. taxpayer to reduce their footprint in the mortgage market. In your testimony, you note that the Government should begin to reduce its participation at least in one way by the reduction of conforming loan limits.

As we consider appropriate transition away from the status quo, do you have suggestions as to what rate and on what timeline we should proceed? Do you believe that the private market could readily absorb a larger percentage of the mortgage market now?

Mr. HUGHES. Yes, I would think it would have to be done on a safe and measured basis. You know, I can see it coming down—if it came down by 5, 10 percent each year for several years, to bring it back down in line. I think the conforming loan limit, if we went back to the old OFHEO standards on how it would be calculated, the loan limit today would probably be $330,000. So I think it is—but it needs to be done on a basis where there is not a shock to the system, and I do think private capital steps in in one of two ways: either through banks' balance sheets or through private securitization.

Senator CRAPO. Thank you. And, again, Mr. Hughes, on another matter, investors in the mortgage markets need certainty. Senate bill 1217 in Section 223 calls for the development of uniform securitization agreements and definitions of reps and warranties for securities that are covered by the guarantee.

As one of the few people who have been able to put together a private label deal in this crisis, could you please describe how you have approached these issues?

Mr. HUGHES. Yes. So when we initially opened up or tried to open up private securitization, we reverse-engineered from investors to figure out what would be best practices. And for us, best practices are, again, a complete rewrite of reps and warranties, binding arbitration, and another feature that Redwood has is that we invest in the credit securities. So you as a senior investor know that the person that is actually selling you the securities has, in Dodd-Frank parlance, "skin in the game." But we have found that, you know, investors will come back to the extent that there are best practices.

Senator CRAPO. Thank you.

And, Mr. Gidman, you noted in your testimony that some local governments are exploring utilizing eminent domain to seize underwater mortgages from private investors and restructure them into more favorable terms for the borrowers. In fact, one municipality—Richmond, California—has even voted to move forward with the idea and is actively recruiting other cities to join it.

As a long-time industry participant in the mortgage-backed securities market, what have you observed to be the impact of this proposed use of eminent domain on prospective investors in private mortgage securities?

Mr. GIDMAN. Thank you, Senator. I think there has not been an impact yet because our industry generally believes that it is highly unlikely to occur. However, the recent action you alluded to in California, it certainly becomes more possible.

Speaking specifically about the legacy PLS issue and the challenges that homeowners face with mortgages that are underwater and struggling to pay those mortgages every day, we strongly advocate for the expansion of HARP to private label securities. We think that provides a transparent, public policy, standardized mechanism to address many of these needs.

With regard to eminent domain, when we look at the recently introduced Housing Finance Reform and Taxpayer Protection Act, it is well structured. It is comprehensive. It aligns interests. It promotes transparency. But a critical component of it is investors taking first-loss risk. If the Federal Government allows, in our view, the use of local eminent domain powers to undermine national housing policy going forward, investors will not be able to take on the first-loss risk in the future.

In our view, in order for GSE reform to have a chance at success, the Federal Government needs to use its tools now preemptively to protect the housing finance market.

Senator CRAPO. Thank you, Mr. Gidman. And one more question for you on another topic—assignee liability. You noted in your testimony that Dodd-Frank expanded legal vulnerabilities that creditors, assignees, or other holders of a residential mortgage loan may be subject to if they initiate foreclosure. This creditor or assignee liability has been cited by many experts and participants, such as you, as being one current impediment to the return of private investment in mortgage-backed securities.

Could you please explain further why you believe the assignee liability issue is so negatively impactful on how private capital views the mortgage market?

Mr. GIDMAN. So I think this really goes back to the central role and the question of the trustees and whether or not they have a duty to act solely in the best interests of the trust or whether or not conflicts inherent in vertically integrated financial services organizations that provide origination, issuance, servicing, and trustee services will be so conflicted that they are not able to act in the best interests of the trust.

We believe that, given our recent experience with the AG settlement, where originators of bad loans, organizations that were involved in predatory lending were able to pay with funds by trust investors, including pension funds and other institutional investors. There has been a recent case that is in the press which is not yet settled, but we are very skeptical about where $4 billion of those dollars might come from, because we saw what happened in the AG settlement.

And so the shame for us is that without greater transparency and alignment of interests, particularly around the role of the trustee but also the servicer, it is really putting a gate in front of the entire trillion dollar PLS market potential.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, and thank you, Ranking Member Crapo, for having this hearing.

And I particularly want to welcome Mr. Gidman. Thank you. I am glad you are here from Massachusetts. I understand you are from Hull, and so welcome and thanks for your work with the Association of Institutional Investors. It is really important work.

I want to ask a question about countercyclicality. You know, we have seen that the housing market is naturally procyclical, that when things are going well, lending becomes overextended; and when things are going poorly, lending decreases dramatically.

So I believe it is important for regulators to have the authority to exert countercyclical pressure on the housing market. Peaks will not be so high, but the valleys will not be so low, and that reduces the risk of a future taxpayer bailout.

So one way to exercise countercyclical pressure is to raise Government guarantee fees during boom periods and lower them during declines in the market. But that will not work unless the regulators have authority to exert countercyclical pressure on the private label market as well. Otherwise, when guarantee fees go up during the boom period, it will just drive everyone over to the private label market.

So my concern is how regulators can exert countercyclical pressure on the private label market. Professor Levitin, could you weigh in on that?

Mr. LEVITIN. Sure. There is a tool missing in the regulatory toolbox, and that is that regulators do not have the ability to control the amount of leverage in the housing finance market. In other words, the tool regulators need to have is the ability to limit combined loan-to-value on new mortgages being originated at any point in time.

So regulators can affect the housing market by interest rates, but that affects—that is a blunderbuss. It is not a surgical tool for the housing market. It affects other markets. Controlling loan-to-value limits, if you gave it to a regulator—I am not sure which, but let us say the Federal Reserve—that would give them a targeted tool for dealing with overheating of the housing finance market, and this is something that is actually done outside of the United States in some countries. Hong Kong—it is a small market, but Hong Kong does this. Canada and Spain have systems that get to a similar result even though it is not formally through LTV limits that apply to originators.

Senator WARREN. Yes. So let me just ask, Mr. Hughes, do you agree as an issuer of private label securities that the Government should address the inherently procyclical nature of private label housing finance market?

Mr. HUGHES. I would agree.

Senator WARREN. And would you agree with Professor Levitin's suggestion of a tool doing it by regulation of loan-to-value ratios, or would you do it a different way?

Mr. HUGHES. I think loan-to-value ratios are important. They have been overlooked in QM or QRM. I think, you know, what investors look at from an investor side, the most important criteria in determining whether there is a risk of default, it is the amount of equity in the property. Yes, I think that would be one important way of——

Senator WARREN. So you would support some regulation in this area.

Mr. HUGHES. Correct.

Senator WARREN. And, Mr. Gidman, would you like to weigh in on that?

Mr. GIDMAN. I agree with your observation completely. The GSEs or the Federal Government play an important role in housing finance to provide that countercyclical capability. You know, I think QM and the LTV ratios have been discussed as a key component, but another one could be in terms of levers that are available to the Federal Government is capital ratios with the originators.

Senator WARREN. Got it.

Mr. GIDMAN. But there are tools, there are mechanisms, and what we do not want to happen is for GSE reform to be procyclical rather than provide the backstop that is necessary in terms of crisis.

Senator WARREN. Right. Thank you very much.

Let me ask one other question. Even if the private label market represents only 20 percent ultimately of the overall housing market, it still would be a multi-trillion-dollar market that it is dealing with. Given the size and importance of the market, I worry that there will still be an implicit Government guarantee that will affect the risks taken on by private actors.

So I hear from a lot of people that the new QM and QRM rules, along with the SEC's eventual revisions to Regulation AB, will adequately limit the risk that can be taken on by participants in the private market.

Professor Levitin, do you agree with that?

Mr. LEVITIN. I am not sure, but I have concerns. We do not know exactly what the final QRM rule will look like, much less Reg AB, which seems much less advanced in its promulgation.

To the extent that loans are QM, it will significantly limit market risk by ensuring the borrowers have the ability to make monthly payments, but there is not an LTV component to QM, as noted.

What makes me more skeptical—what makes me skeptical here is that I think that a fair amount of the market eventually will not be QM. My impression is that a lot of the financial services industry does not fully understand QM and the consequences of a mortgage not being QM. There is actually a fairly weak remedy provision.

If a mortgage is underwritten without ability to repay—I guess it is not underwritten in that sense—and it does not happen to meet the QM safe harbor, there is no penalty just for that. There has to also be a default on the mortgage. There has to be a foreclosure following that default. The homeowner is going to have to be willing to litigate the foreclosure. So we are talking about really a very small number of cases. And then if that happens, the homeowner has a defense in the way of set-off against the amount of money owed, but it is actually a very small set-off by statute. I think there is some interpretive room in the statute, but I think in most cases we are probably talking basically about set-off of attorneys' fees plus $4,000. That is not a lot. There really is not much risk from a mortgage not being QM. I think once the market understands that, a lot of mortgages will not be QM.

Senator WARREN. All right. Well, I am very concerned about this, but I see that I am over my time, so I am going to—I very much want to hear from the others. I will submit questions for the record.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for coming in and for meeting with members of the staffs and members here just about the best way to go forward and for the work of your organizations.

I think what all of you have said is that the model that a large group on the Committee are looking at that puts private capital in front of any kind of Government backstop is a very good model to go alongside private label financing. Is that correct? And would you like to expand? Go ahead.

Mr. HUGHES. Yes, I do think it is a good model. Obviously, you know, if we develop into three markets where you have a totally Government-supported market, a hybrid market where private capital takes the first risk, and then a totally private—you know, through private label securities, I think is the right blend of mortgage tools to have adequate liquidity in the marketplace for borrowers.

Mr. GIDMAN. When we look at the mortgage markets, we look at it as a whole. We think there is a component which is a GSE and an explicit Government guarantee, and there is a purely private, but they need to work hand in glove. And when we look at the framework that has recently been introduced, we think it is thoughtful, and it is well structured, and it provides a mechanism that would naturally provide that to happen.

Going with, you know, reducing conforming limits on their own, no matter how measured the pace, will not bring private money back into the market without the kind of structural reforms specifically around the role of the trustee, reps and warranties, and transparency and timeliness of loan-level data. But we think there is more than enough room and there is certainly pent-up demand.

Senator CORKER. OK.

Mr. LEVITIN. I would agree with everything that Mr. Hughes and Mr. Gidman said, that we have three markets: the Government, the hybrid, and the private label market. All of them need reform. I think the Committee is quite well aware of the issues with FHA right now, but the core part of the market is going to be the hybrid, and that is I think where we need to pay a lot of attention, but we still need to also do reforms, as Mr. Gidman noted, for PLS

Senator CORKER. So one of the things the bill seeks to do is to create uniform PSA to have a clear definition of reps and warrants, to have electronic registration so that it is regulated, create uniform data so investors can actually analyze data sets, and very importantly, I think, make sure that second liens cannot just be piled on the first liens without the first-lien investor being aware of that.

Are these helpful, are these steps that are in this bill, proposed bill—an actual bill, I guess, are these helpful in bringing in private capital? And would they also be helpful if some of those standards, as I think Ms. Warren was alluding to, if those standards were also evident in the private label market itself?

Mr. GIDMAN. We think that that language and those provisions that you mentioned are extremely helpful, but they are not sufficient without some of these other structural reforms that all of us have talked about.

We think that, you know, it is a really promising approach. It is very well engineered in terms of the overall bill, and it addresses almost all the concerns that institutional investors would have.

Senator CORKER. OK.

Mr. HUGHES. I would echo that. I also thank you for putting in the second-lien provisions. But we would be an investor. We invested in the Freddie Mac transaction in STACRs. We are a company looking to take and invest in mortgage credit risk. And there are different ways to express it. If we can express that through the private label market, totally private, we will do it there. But we would also, you know, be very open to putting private capital ahead in a hybrid type model.

Senator CORKER. OK. Well, listen, thank you for your testimony, and especially mentioning some of the things that you think can make legislation even better. I think all of us who have been working on this for some time realize there are a lot of improvements that can be made, and we appreciate your testimony and look forward to trying to incorporate some of the suggestions you have made into the bill that has been produced. So thank you very much.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, gentlemen, for your testimony.

Mr. Hughes, you suggest in your testimony the need for service performance triggers, servicers, so that servicers effectively can be, you know, removed if they are not functioning properly. And Chairman Johnson and Senator Crapo were very helpful in getting language in the FHA Solvency Act which would have a similar situation where a servicer could be removed and an approved servicer would replace them.

Can you comment on just the need for these triggers for servicers?

Mr. HUGHES. Yes. I think it is critically important that from an investor's standpoint, if a servicer is not following their responsibilities under the agreement, that there is some mechanism to remove them. If there are conflicts, if they are not resolving problem loans on a timely basis, if they are not giving good service, you know, like under any other contract, I think there should be provisions, if you do not live up to the terms of the contract, you should be in a position where you could be removed.

Senator REED. Thank you.

Professor Levitin, I want to get back to a point that you raised with the Chairman, and that was—and I think both Senator Corker and Senator Warner have done a superb job in sort of advancing dramatically the progress on the bill. But one of the premises is 10-percent private capital up front. The question is: Is that sufficient? Or is it too much?

The other question is: It could be private capital in the transaction investing into the entity, but it could be raised by debt on the other side, which would—essentially be a lot of leverage that is—we saw that in the crisis. Do we have to worry about both those things?

Mr. LEVITIN. I think potentially we do. Whether 10 percent is the right amount, I do not have an opinion on that. I think we would want to get as much first-loss private capital as we can. You know, the higher you raise it, the better that would be in terms of protecting the public fisc. But it is also a question of what constitutes that first-loss capital and what is really backing it up. And I think you are right to be concerned about the need to look through what is capital for, let us say, FMIC purposes in S.1217 and say, well, really, that is only backed up by more borrowing. Are we just building a pyramid of leverage? I think that is a concern.

And one area that I think S.1217 could be improved in is being more explicit in what constitutes capital for bond guarantors and for any kind of private label execution of the 10-percent first-loss piece.

Senator REED. There is another aspect, too, as you alluded to in your responses, that there are times when the market can provide adequate capital, the market is, you know, actively, and eagerly looking. And then there are times of economic distress when there has to be more sort of Government involvement. So that would suggest that this capital number would have to be sort of adjusted, if you will, for public policy purposes by the Government.

Is that a fair, general assumption?

Mr. LEVITIN. I think it is, and I think that there is reason to have some concern about that, because to the extent that you have an accordion-like Government commitment to the market, that raises the possibility of—it raises the question of who is exercising—who is playing the accordion and how politicized is the accordion going to be played.

The Corker-Warner bill is cognizant of the need—you know, of the need for the Federal Government to step in if the market runs into real trouble. There is a provision in the Corker-Warner bill; it is a limited provision, though. It lets FMIC step in and waive the 10 percent for, I believe, 6 months. Hopefully that would be enough time, if necessary, for FMIC to get an extension from Congress. But I worry about any bill that requires the system to come back to Congress. I mean particularly with what is going on right now——

Senator CORKER. Yes.

Mr. LEVITIN. ——I worry about whether the political system is going—will function.

Senator WARNER. Shocked. Shocked.

[Laughter.]

Senator REED. I have another question, but I think you have answered all the questions with your last response.

I think one of the issues that we are trying to collectively come up with an appropriate response to, is how do we have a system that is, you know, independent of pressures other than responding to the market conditions. I mean, one of the examples that we have lived through, the long, long, slow rise of the mortgage market from the depths of 2008, 2009, if there had been a 6-month statutory window, that window might have been too small.

So, again, I think we have got to think harder on some of these issues. But what Senators Warner and Corker have done already has been extraordinarily helpful.

Thank you.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and thank you to the witnesses for being here.

In the interest of time, maybe I could just posit an assumption—and by all means, correct me if I am wrong—that all three of the panelists would agree that if municipalities did begin to claim eminent domain as a power, a justification for confiscating mortgages, that that would have a chilling effect on the ability to attract private capital into the mortgage market. Mr. Hughes, do you agree with that premise?

Mr. HUGHES. Absolutely.

Senator TOOMEY. Mr. Gidman, I think you generally did in your response to Mr. Crapo's——

Mr. GIDMAN. You would have no need to proceed with GSE reform.

Senator TOOMEY. OK. And——

Mr. LEVITIN. I am not prepared to totally agree.

Senator TOOMEY. OK.

Mr. LEVITIN. I think it really depends on the scale that we see. To the extent that there are eminent—I am not a supporter of the eminent domain proposals that exist. But I think it is important to recognize why they exist. They exist because of a failure in the servicing of mortgage loans, and that needs to be addressed. Once it is, we will not have the eminent domain proposals.

Senator TOOMEY. And presumably one of the reasons for concern about using eminent domain this way is the rule of law and the sanctity of the contract and the importance that—well, our entire society, but in particular private investors would place on being able to rely on a contract. So I wonder if anybody has any concerns about the FHFA's third amendment to the preferred stock agreement where it could be argued that the Government unilaterally changed the terms of an agreement that had been in place. I want to give a quick quote and ask your reaction.

Randy Guynn is the head of the Financial Institutions Group at Davis Polk and an expert on bankruptcy and related matters for decades. He stated last week at an NYU seminar on the GSEs—and I will quote. He said, "If the Government gets away with the dividend sweep of Fannie and Freddie, it will establish a dangerous precedent for the rights of analogous stakeholders of failed banks and systemically important financial institutions under the FDIA and the OLA." And I might add to that list any potential successor to Fannie and Freddie.

Do any of you share a concern about that? Mr. Hughes.

Mr. HUGHES. I am not an expert in the area. I really do not have any insights.

Senator TOOMEY. OK. Mr. Gidman.

Mr. GIDMAN. I do not either. I am sorry.

Mr. LEVITIN. I do share your concerns on this, and I would note it does not just affect investors, but it also affects the Affordable Housing Trust Fund, which the Federal Government has not been paying into.

Senator TOOMEY. Thanks. Then let me switch topics here since we did not get too much discussion on that topic.

Dr. Levitin, you indicate in your testimony that you believe that the capital markets would be able to support no more than $500 billion annually in mortgage credit risk, which considering the size, the multi-trillion dollars of credit risk that investors routinely take, private investors take in corporate bonds, commercial paper, financial—you know, short-term financial paper, consumer credit of various kinds, how do we know that there is only $500 billion worth of demand for credit risk in the mortgage market?

Mr. LEVITIN. Sure. I cannot say precisely that it is $500 billion and not 499. This is a ballpark figure. But I think that we can see the ballpark figure is not even close.

The reason that we—the basis of my analysis is looking at the private label market in the past, that before 2004, we had a private label securitization market, and it never amounted to more than 15 percent of——

Senator TOOMEY. But didn't it always have to compete with the Government-guaranteed market, at least implicitly?

Mr. LEVITIN. Sure, but to the extent that you do not have a Government-guaranteed market, if you just got right of it——

Senator TOOMEY. Right.

Mr. LEVITIN. ——the money that is invested in the Government-guaranteed market is not money that is investing in—that is taking on credit risk. Those are interest rate risk investors. Some of them might be willing to take the A piece in a private label securitization, sort of the senior piece, but placing the B piece is much more difficult, and it is just not—I do not see any indications that there is a large pool of money willing to take on first-loss credit risk on U.S. mortgages.

Senator TOOMEY. Isn't it true that the nature of the credit risk on a mortgage declines over time? I mean, if you—the duration of a mortgage, the average life weighted by any reasonable measure, is typically less than 10 years. By the time you are approaching 30 years on a mortgage, credit risk is often becoming de minimis because the loan-to-value ratio is becoming so good.

Mr. Hughes, do you agree that there is only $500 billion worth of private capital willing to take credit risk in mortgages?

Mr. HUGHES. I think it is probably not a—probably a fair estimate, but the real questions are—you know, the way I would look at it is if you did some tranching of the 10 percent, such that you could get people like Redwood, who would be, you know, happy to come in and try and take the first-loss credit risk and then tranche it up so that you access different pockets of investors with different risk profiles rather than just say put everybody in the 10 percent.

You know, having said that, the 10 percent is a pretty large number, and I look forward to understanding more about how much that is going to be capital, can you use any kind of leverage, and how would it work. But I think in particular, some tranching of that so that those people best able to take the risk, the deep credit risk, are in that position.

Senator TOOMEY. I see I am out of time, Mr. Chairman, but I would just observe that we have private investors who routinely take trillions of dollars worth of credit risk year in and year out across an enormously wide range of securities, and why we would assume that suddenly there would not be a willingness or ability to match investor demand with the corresponding section of the mortgage industry, I find that baffling.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I want to thank you and Ranking Member Crapo for your work in holding these hearings.

Picking up on Professor Levitin's comment about our functionality, or lack thereof, I just want to again make the appeal to you—and I know the staff is working very hard on this issue—that time is not on our side in GSE reform, that this may be the one area under your leadership where there is broad bipartisan agreement and we could actually not only get a bill out of Committee but on to the floor.

I am afraid that the forces of the status quo at some point, and the notion that we would have a system, when you kind of reflect back, that has a private entity in the old model, that has shareholder value, appreciation goals, Government backstop, and public service goals all wrapped into one in any kind of ongoing, functioning entity just, you know, as somebody who has looked at this, does not seem like it makes a lot of sense.

I do want to make a couple comments following up on Senator Toomey's comment. Professor Levitin, I do not know whether your $500 billion number is right or not. It seems relatively reasonable to me. I would argue that in the hybrid proposal, S.1217 has suggested we expect to see a growing PLS market. That is going to take private capital. And with the 10-percent private capital risk guarantee on the hybrid model, that is going to take capital, too. So I think, you know, that number may expand a bit, but I think that it is kind of a reasonable assumption. And I will come to a question here ultimately.

I guess the other part I would make—and I think that both Senator Reed and Senator Warren raised this issue on the countercyclical, and I think there are ways perhaps it could be improved, but there is this notion—I think there is a recognition that 1217 has, that there are ability of three keys—we put the Fed, FMIC, and Treasury to turn that down if private capital flees. So we do not have a system where we are kind of left without any tools at all. Maybe there are ways to improve it. And I think Senator Reed's comments were good as well, and I want to again come to Mr. Hughes.

One of the things that I have thought—and we have had a lot of discussion on the 10-percent number. We all believe skin in the game. You have talked about the value of private label, Mr. Gidman has as well, skin in the game. Clearly, 1217 puts a lot of skin in the game, which, again, better guarantees that that Government backstop will never be hit. That is more than double what would have been required in the last crisis. And Professor Levitin has raised I think the appropriate question. You know, does 1217 get the definition of capital right? Which is terribly important, and I am anxious to hear more feedback.

But I want to come back to Mr. Hughes and maybe all three of you to comment, not only definition of capital, but if you have got that 10 percent—let us assume for argument's sake that we have struck a bit too high, which I would rather err on the side of safety. But shouldn't there be an ability perhaps to tranche part of that? Can't the market be a better—have a better ability to figure that out—and, respectfully, as smart as these Senators are and our staff are—than a group of legislators? So can you drill down a bit more on that tranching idea? And I would like to hear from each of you.

Mr. HUGHES. Yes, I think it is incredibly important to do some tranching because investors have different risk profiles, and on the private side, totally private side, in, you know, a PLS transaction, the senior investors are bringing most of the capital, but most of the risk is in the subordinate securities, you know, below that. So, again, I would think, you know, if the number was 10 percent, or something, breaking that down probably—if you would expect in this pool of loans probably you are going to have—25 basis points of loss would probably be a reasonable assumption for well-underwritten that maybe, you know, you tranche out the first 2 percent, which would be 5 times—which would be 10 times coverage and then, you know, move up from there. But, yes, I think it would be a very appropriate way of attracting capital.

Mr. GIDMAN. So we think we agree that the tranching is particularly important, but in terms of the absolute number or prescribing the number at 10 percent, we really believe that it is an important lever, countercyclical lever for the market, and that it should not be necessary to come back to Congress to change that lever. We think that it is something that the Federal Mortgage Insurance Company should have as a tool in its toolkit.

Mr. LEVITIN. There are certainly ways to tranche the 10 percent. It could be tranched on the initial issuance, or it could be tranched subsequently. Basically you could—someone could buy that 10 percent and resecuritize it, issue tranched credit link notes. There are lots of ways to allocate that 10-percent credit risk within the market.

I am not real concerned about that, even though there may need to be some adjustments to the QRM rulemaking to make sure that if the market wanted to retranche the credit risk, it would not—there would not have to be extra capital help because of that.

Senator WARNER. Well, again, I want to thank all the witnesses for their testimony and the fact that they have endorsed the directional approach, and I am, again, looking forward to working with the Chairman and the Ranking Member to fine-tune and get this right. Again, I just hope and pray that we do not miss this window.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you, and let me, if I might, join with the comments of Senator Warner. I think we have a window of opportunity here, but I think that window closes for a whole variety of reasons that I will not go into. But I really appreciate what the Chair and Ranking Member are doing here because I think they are laying out a process by which we take some bipartisan ideas and then build a final piece of legislation.

In that vein, some months ago the Chairman brought us all together in kind of an informal work session and went around the room to the Banking Committee Members and said basically, "Tell me what you would like to accomplish through GSE reform." And we had an opportunity to list the three, four, five, six things, whatever, that were important to us.

I would suggest in a pretty bipartisan way members listed the 30-year mortgage as one of the things that they would like to preserve at the end of GSE reform.

We have not touched on that today that I recall, and I would like to hear your thoughts on the importance of making sure that whatever structure we end up with keeps that 30-year mortgage opportunity in place. And, Mr. Hughes, I will start with you, but we will just go right on down the table.

Mr. HUGHES. Yes, I think keeping a 30-year fixed-rate option available to borrowers I do think is very important. There are all sorts of other options down the spectrum that you can get through hybrid loans, whether it is 5 years, 10 years. But I think giving a borrower the option where they can be fixed for 30 years, if that is what they want, is important.

Senator JOHANNS. Great.

Mr. LEVITIN. From a policy perspective, we agree that a 30-year mortgage is an important vehicle for borrowers.

Senator JOHANNS. Great. Professor.

Mr. LEVITIN. A 30-year fixed-rate mortgage is the keystone of the American housing finance system. It is a uniquely American product, and it is one that has served the American people very well for nearly 75 years now.

It is important to recognize that the private label securitization market has never produced 30-year fixed-rate mortgages on a wide scale by itself. Basically, if you want to do lots of 30-year fixed-rate mortgages, you need to have some sort of Government guarantee. That is how the 30-year fixed was created in the first place.

Senator JOHANNS. Mr. Gidman, do you have something to offer on that? I noticed that you were listening to that testimony closely.

Mr. GIDMAN. Well, I think the professor is generally right in terms of the history, but I think there is room in the market for private label securitization out, you know, well beyond 10 years. But as a foundation of the housing finance market in the United States and uniquely American, the 30-year mortgage is very important.

Senator JOHANNS. Great. There has been a lot of discussion as the legislation was put together about the 10-percent—I do not know what you would call it—"skin in the game" provisions or whatever. We had a witness a few weeks ago that talked about 5 percent, you know, and I guess you can debate those numbers.

I am fascinated by this idea of tranching, and I would like to hear from somebody a little more thoroughly on how that would be set up, how that would work, because the one thing I want to avoid from my vantage point is, you know, the wizard adjusting the dials on the economy and dial this and dial that. I want more market forces involved in this. So talk to me about how the tranching—Mr. Hughes, we will start with you again.

Mr. HUGHES. I would envision very similar to how the PLS market works right now. So in our transactions, there is tranching of bonds of—up to probably 93 percent is AAA.

Senator JOHANNS. OK.

Mr. HUGHES. And then 7 percent below that is a series of securities. The deepest credit securities is probably 2 percent, and then you work your way up from BBB, A, AA securities. And really what happens and why tranching is important is losses go from the bottom such that if there are losses in a Redwood deal, the first bond that gets torn up is our bond, but the bond above us is protected until our bond goes away.

So, therefore, investors have a different risk depending on where they are on that tranching. So somebody may be more comfortable at the AA level. Where we would be more comfortable, you know, we think there is more yield and opportunity at the deep credit level.

Mr. LEVITIN. The one concern I would raise with tranching is that tranching creates conflicts between investors potentially, that when you have a security that is not a complete pass-through for all investors, you are binding longs and shorts together in the same deal, and they are not going to want the same things, be it on interest rates, on things like cleanup calls and deals, on servicing, and I think that puts a lot of pressure then on making sure that the trustee and servicer provisions and the deals are done right, and there is, I think, a very important set of reforms that need to be done in that space.

Senator JOHANNS. OK. Mr. Gidman, did you have anything to offer?

Mr. GIDMAN. I do, yes. Tranching opens up the deals to a greater world of investors because it allows you to taper the risk and target it to the investors that have the appropriate appetite. But what the absolute number is and how that tapering or tranching occurs I think is a market force that could be guided by a Federal institution.

Senator JOHANNS. OK. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Heitkamp.

Senator HEITKAMP. Thank you so much, Mr. Chairman and Ranking Member. I think these hearings have been extraordinarily helpful to me as we kind of work through this process.

My questions are really just twofold, and one is about the timing of reform. And I think what you hear is a sense of urgency in this room that if we do not do this fairly soon, we will not have the opportunities for reform, even in a year, that we have today. And I just want to get kind of affirmation of that because I sense some urgency, but like we know, nothing very—nothing happens very quickly in this place, as I am finding out as a new Member.

Professor, can you tell me what you think is right now the window for the maximum number of options that we have to do reform correctly?

Mr. LEVITIN. I want to be careful that I do not expressing my opinions on what is politically feasible.

Senator HEITKAMP. Just imagine the moon. Imagine the moon. They will do whatever we want to do.

[Laughter.]

Mr. LEVITIN. We need to fix this market. It is not in an acute condition where it needs to be fixed tomorrow. I think it is more important that we get this right than that we do it sooner. I would, therefore, probably err on the side of caution.

Senator HEITKAMP. What timeframe?

Mr. LEVITIN. Timeframe, I mean ideally, you know, all else being equal, you want this done as soon as possible, but I think it has to be done right. I do not think I can really lay out a timeframe for doing this.

Senator HEITKAMP. Mr. Gidman.

Mr. GIDMAN. Our view really is that the time is now. The framework that has been laid out there is very thorough, it is comprehensive, it is well engineered. The structural fixes that we have sort of identified we think are—there should be bipartisan agreement on that.

The thing that we are concerned about that makes this more timely from our standpoint, again, is back to the eminent domain issue. If a single municipality exercises eminent domain to seize performing loans, regardless of the public use arguments, regardless of fair value arguments, if they do that, it will make it very difficult for institutional investors to remain in that market let alone increase our involvement in that market, which could make efforts toward GSE reform moot.

Senator HEITKAMP. If I could just, before we move on to Mr. Hughes, make the point, I think you said earlier in your testimony that there have not been adjustments for the eminent domain issue as of yet because you do not see this as catching fire and spreading across the country in a large way today. Is that correct?

Mr. GIDMAN. We think it is so harmful to the national mortgage markets that ultimately the Federal Government will step in with its tools to make sure that it does not happen.

Senator HEITKAMP. So your risk evaluation on the eminent domain issue is more based on being able to come here and, you know, create a firewall, so to speak.

Mr. GIDMAN. Well, we look at the recent letter from the FHFA, which directed the GSEs and how they should act with regard to the municipality. But we think it is really not an issue of a single municipality or a single approach. We think it is a national housing finance policy that you all would be highly incented to protect.

Senator HEITKAMP. Mr. Hughes, your thoughts on timing?

Mr. HUGHES. Yes, I have a high sense of urgency to get something done. I would think you would want to do changes to the PLS market hand in glove with anything that may get done with the enterprises. I think there will always be arguments it is too complicated, the TBA market is not going to do it, and there will be all sorts of bogeymen out there. But at the end of the day, you need to tackle it. You need to start it. You need to begin a process and to resolve those things.

Senator HEITKAMP. One last question, and it is directed to you, Mr. Gidman. You had suggested that there was room in the private market for the 30-year fixed-rate mortgage. Can you tell me what the impediments are today for the private market to get involved in the 30-year fixed-rate mortgage and explain why it is that in your earlier testimony you were talking about million-dollar houses with 50-percent equity? You know, why aren't you taking the $300,000 home on a 30-year fixed-rate today?

Mr. GIDMAN. Well, I think, you know, the critical factors for us are not the size of the loan. It is the quality of the loan, it is the amount of equity in the property, it is the lack of other liens and weights on that loan. And I think without the structural repairs with regard to the role of the trustee, the uncertainty around assignee liability or eminent domain, it is very difficult for us on behalf of our clients to embrace innovation further down the range of the mortgage market.

Senator HEITKAMP. Just begging the indulgence of the Chair, so if some of these issues were addressed, you would see more active participation.

Mr. GIDMAN. Yes, I think you would.

Senator HEITKAMP. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman and Senator Crapo. Thank you both for doing this hearing.

In 2011, Congressman Brad Miller of North Carolina and I introduced the Foreclosure Fraud and Homeowner Abuse Prevention Act to make the securitization process work better for investors and for borrowers. You have in your testimony supported some provisions of that bill which I would like to ask you about—mention and then ask you about: one prohibiting mortgage servicers from holding a second lien on property that has a mortgage they service. Senator Corker mentioned that. Mr. Hughes and Professor Levitin suggest that second liens can create perverse incentives, as you know, particularly when the same party is servicing the first lien.

Like Mr. Gidman, I was concerned about the national mortgage settlement affecting mortgage investors. I warned Secretary Donovan that investors in pension funds for working Ohioans, for example, should not pay for Wall Street mistakes. Unfortunately that is what happened.

My legislation with Congressman Miller would clarify that bond holder protections in the Trust Indenture Act apply to mortgage-backed securities investors, as Professor Levitin suggests.

Mr. Gidman, you noted that vertically integrated financial institutions often serve as issuers, trustees, originators, and servicer, sort of the whole vertically integrated, if you will, creating conflicts of interest and incentives not to identify deficiencies that harm investor trust. If all three of you would briefly in a minute or so discuss why the reforms that you have proposed that are in our bill are important protections for investors, including applying the Trust Indenture Act, and how these reforms will address these clear conflicts. Mr. Gidman, do you want to start?

Mr. GIDMAN. Yes, I think that the current language that has been proposed goes a long way toward addressing those structural issues that we have all talked about, whether it is standardization of reps and warranties, ready availability and timely access to loan-level data, and alignment of interests.

Mechanically—you know, we use the term "fiduciary duty" in my industry because that is what we know, that is what we live under. Whether it is a fiduciary duty or whether it is a fix to the Trust Indenture Act, I am not sure what the right mechanics are. But we certainly know that the trustee needs to act solely in the best interest of the trust, and they need to have the capacity to have effective oversight of their servicers and there needs to be mechanisms for the end investors to be able to have enforcement that has teeth and rights of private action for breach. We think all of those are important.

Senator BROWN. OK, and the fiduciary duty is part of this.

Mr. Hughes.

Mr. HUGHES. I would echo most of that. I do believe you need a mechanism within the trust to actually enforce rep and warranty claims. I would say to me the biggest single failure of private label was the fact that the reps and warrants either were weak, they became unenforceable, and it was the basis for all the lawsuits that we have today. So I think having discipline beforehand very clear on servicers' responsibilities, representations and warranty, what the authority of the trustee is, what the authority of a credit risk manager is, is incredibly important in bringing back institutional money to this space.

Senator BROWN. Professor Levitin.

Mr. LEVITIN. Yes, there is really nothing new under the sun in the financing world. The Trust Indenture Act was a response to vertical integration in the mortgage bond market in the 1920s.

There is a huge SEC report from 1936 written by William O. Douglas and Abe Fortis, two future Supreme Court Justices, detailing all of the abuses. It reads like the playbook for what we have seen going on in the last few years.

I think the ultimate—you know, fiduciary duties are important, but trustees have fiduciary duties after there is an event of default for a trust. The problem is getting to that event of default, and I think what the—part of the solution needs to be to split up the different duties the trustees do. They have some ministerial functions, they have some financial guarantor functions, and they also have an enforcement function. The enforcement function needs to be split off from the other functions and given to a party with no conflicts whatsoever, and also fiduciary duties.

Senator BROWN. Thank you. Let me ask Mr. Gidman and Mr. Hughes a question about PLS accountability in terms of both employees and institutions, and I want to read something that was in Mr. Levitin's written testimony: a "study by the Center for Public Integrity found that senior executives from all of the 25 top subprime lenders during 2005–2007 were back in the mortgage business as of 2013 . . . it is easy enough to move from the securitization desk of a failed investment bank to another or to an investment fund. The lack of SEC and DOJ prosecution of either individuals or institutions related to pre-2008 PLS merely underscores the lack of consequences of securitizing noncomplying mortgages . . . it is unlikely that reputational sanctions are sufficient to keep the PLS market in check."

Just briefly, do you agree or disagree, Mr. Gidman and Mr. Hughes?

Mr. GIDMAN. I had not heard that statistic before. What I do know is that greater transparency and alignment of interests can go a long way toward protecting the integrity of the market going forward, and those are lessons that we should have learned from the crisis.

Senator BROWN. Mr. Hughes.

Mr. HUGHES. A couple things. First, I sign a certificate with each securitization we do that goes out under my signature.

And I would say, second, I think a very important part of it from a Redwood Trust standpoint is that we actually hold skin in the game. We actually hold the credit securities as incredibly important because, you know, we represent shareholders. If we are putting together a bad pool and there are consequences to investors for that pool, the person that is going to bear the most risk for that pool is Redwood Trust.

Senator BROWN. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Merkley.

Senator BROWN. He is not here.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman and Ranking Member, and I do appreciate you holding the hearings, and I, too, agree that there is a sense of timing for GSE reform, and I appreciate this hearing.

I wanted to follow up on Senator Heitkamp's question on eminent domain, and I know that Senator Toomey also started talking about eminent domain. Mr. Gidman, you reiterated to Senator

Heitkamp your thoughts. I was just wondering, Mr. Hughes, if you could talk about the eminent domain proposals that are out there and how that could be bad for investors and for businesses—and for borrowers.

Mr. HUGHES. You know, if it went through and that became a way of taking over property that would belong to investors, I think it would have a dramatic effect on private securitization.

Senator HAGAN. And when you say "dramatic effect," can you expand on that?

Mr. HUGHES. I think if you are an investor and you now have a risk that someone could take your collateral out of your pool and you do not get adequate compensation for that, yes, I think that would be a risk that you had not planned on.

Senator HAGAN. Mr. Gidman.

Mr. GIDMAN. It would lead us to have to price that risk into our decision making, and given a world of asset classes to invest in, I think it would have an immediate and chilling effect on the entire asset class.

Senator HAGAN. And how do you correspond that with the use of eminent domain today?

Mr. GIDMAN. In the case eminent domain today—we will use the Big Dig as the example. It was real property. There was an unquestioned public interest and public use, and the owners were compensated according to objective measures of fair value.

In the case of eminent domain that has been most recently discussed, you know, a local municipality is seeking to use eminent domain to seize assets that are held by retirees and pension participants across the United States, and it is unclear both of the public use in terms of the likely effect of that action within the municipality, and then because it is a private for-profit enterprise driving the deal, it is hard to see how fair value could be paid and have it work out.

We think that this issue is really a public policy issue, and expanding HARP is the approach to keep homeowners in their homes and really have that effort be in lockstep with a broader housing market finance reform.

Senator HAGAN. Thank you.

Mr. Levitin, in your testimony you indicated that the PLS can only provide the financing for at most an eighth of the U.S. housing market's peak annual financing needs. Can you discuss what constrains the size of that market? And how can Government guarantees work together with the private label securitization?

Mr. LEVITIN. There is a limited amount of market demand for credit risk on mortgages that—you know, I might be wrong on the actual number there, but——

Senator HAGAN. How did you come up with that number?

Mr. LEVITIN. By looking historically at the level of investment in the private label securitization market before the bubble, basically taking even—I am assuming that the bubble starts in 2004. Some people might disagree with me. But at 2004 levels, we would only get up to around $500 billion in investment in private label securities.

Even if I am wrong by a factor of 2 or 3, the problem is the math is not even close, that if in peak years we have needed as much as $4 trillion of investment, private label just is never going to be able to support that. It may be an important component of the market, but it is not going to be the backbone of the market. And I think that we need to try and improve the private label component, but we also have to remember that it is not going to be the core of the market.

Senator HAGAN. Mr. Hughes, you mentioned in your testimony that Redwood recently invested in Freddie Mac Structured Agency Credit Risk notes. Can you discuss the benefits of that transaction in more detail? And how are the products able to distribute the credit risk from the GSEs into the private sector?

Mr. HUGHES. Yes, we participated in the transaction. Again, we are in the business of investing in credit risk. We found the bonds to be attractive.

I would note that one of the things in that transaction that I would hope in future transactions they could fix is that they kept 30 basis points of risk at the Freddie Mac level. If you think 30 basis points of risk is the risk in the pool, well, then, it really did not sell the actual risk. And I know part of it was to facilitate getting a transaction done, getting investors in, "Hey, investors, you do not have to worry." My hope would be over time that they would begin to sell first-loss credit risk to private investors——

Senator HAGAN. Thank you, Mr. Chairman.

Mr. HUGHES. ——I think second getting a rating on the bonds would also bring more liquidity because more investors could participate.

Senator HAGAN. Thank you.

Chairman JOHNSON. I would like to thank the witnesses for being here today. This hearing is adjourned.

[Whereupon, at 11:27 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF MARTIN S. HUGHES

CHIEF EXECUTIVE OFFICER, REDWOOD TRUST, INC.

OCTOBER 1, 2013

Introduction

Good morning Chairman Johnson, Ranking Member Crapo, and Members of the Committee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange. I appreciate the opportunity to testify on what can be done to accelerate the return of a robust private secondary mortgage market.

Background on Redwood Trust

Redwood Trust commenced operations in 1994 as an investor in residential mortgage credit risk. We do not originate or directly service residential mortgages. We currently operate a prime jumbo loan conduit through which we acquire individual closed loans from banks and mortgage companies, primarily for pooling and sale through our Sequoia private securitization platform, which creates and issues mortgage-backed securities (MBS).

Senior investors in MBS issued through our platform have protection from credit risk as a result of our investment in the subordinate securities issued in each securitization, which enables the senior securities to obtain triple-A ratings. Although this has not been the case for most issuers of MBS, in Dodd-Frank parlance, having "skin in the game" has always been a component of our business model, which demonstrates our alignment of interest with senior investors.

From 1997 through 2007, Redwood securitized more than $35 billion of mortgage loans through 52 securitizations. The average loan size was $372,000 and, interestingly, 27 percent of the securitized loans were prime loans with balances under Fannie Mae and Freddie Mac's (the "GSEs" or the "Agencies") conforming loan limit. Since we resumed the securitization of newly originated jumbo mortgage loans in 2010, we have securitized an additional $8 billion of loans in 20 transactions. As a result of our securitization and investment activities, we feel well qualified to comment on the state of the private residential mortgage market and the steps needed to increase the participation of the private sector in the broader housing finance market.

To supplement our jumbo mortgage loan business, we recently received our Seller/Servicer licenses from both Fannie Mae and Freddie Mac and we intend to add Agency conforming loans to our product menu. Additionally, we invested in Freddie Mac's recently issued Structured Agency Credit Risk (STACR) notes. This was the first Agency transaction completed as part of the strategic initiative of distributing credit risk from the GSEs into the private sector. Furthermore, we look forward to working with the Agencies to find ways for Redwood to invest in the "first loss" credit risk on the loans we sell to the Agencies, thereby putting the Agencies in a "second loss" credit position.

If we achieve our goals, our business would include investing in the credit risk on both jumbo prime loans (through private securitization) and Agency conforming loans (through contractual arrangements with the Agencies and investments in STACRs and similar investments).

Overview

Broadly speaking, I view the mortgage market as having two distinct sectors. The first is the Government supported sector, which includes the FHA/VA, Fannie Mae, and Freddie Mac. The other is the private sector, which consists of portfolio lenders, primarily banks, and private label MBS issuers, such as Redwood Trust.

Each of these sectors has made vital contributions to the development of the mortgage market over time, for the benefit of millions of homeowners. However, in the wake of the financial crisis, Congress is now appropriately considering how to reform and improve each sector. My testimony will focus on the private label MBS sector of the mortgage market, although it is not possible to discuss reform of one sector in isolation of consideration of reforms in the other sector, as the two impact each other significantly.

The U.S. mortgage market needs multiple financing sources to ensure there are deep sources of liquidity for good borrowers to readily obtain affordable mortgage loans. I would argue that it is critically important for private label MBS to return and play a significant role in mortgage finance, as it has in the past. This can be accomplished by bringing traditional institutional senior investors back to the private label MBS market to efficiently address borrowers' credit needs.

I firmly believe that over the long-term, private label mortgage securitization is a very efficient form of mortgage financing. As a Federal Reserve staff working paper described securitization, it "has the potential to lower the cost of credit to businesses and households by reducing financial institutions' funding costs" and "it can produce securities that cater to the risk-return preferences of investors." Through the securitization process, an investor is able to buy assets that match their appetite for risk, using variables such as duration, interest rate risk, and high or low credit risk. This tailoring of risk is what draws trillions of dollars into the U.S. mortgage market.

Many have speculated on why private label MBS is not fully flourishing today while other asset-backed markets for commercial MBS and credit cards have rebounded. There is no single answer to this question. There are a variety of factors that must be considered to explain the current state of the private label MBS market. Some of these factors will self-correct over time, while others will require structural and legislative change.

Later in this testimony, I will offer specific recommendations for possible structural and legislative changes. But first, I would like to offer the following broad observations about the market:

- As a result of increases in the conforming loan limit, there are fewer non-Agency jumbo loans being created.
- The GSEs have had a significant pricing advantage over the private MBS market. This advantage has been reduced as guarantee fees have increased over the past 2 years.
- Pre-crisis, major banks were significant issuers of private jumbo MBS (especially for 30-year fixed-rate loans). These banks now have over $2 trillion in excess reserves at the Federal Reserve and have made an investment decision to hold significantly more jumbo loans in portfolio to build their asset base and increase net interest income, rather than securitize or sell the loans. For example, in 2012, jumbo loan originations totaled $200 billion and private label MBS securitizations totaled only $3.5 billion.
- Traditional senior investors still have questions of confidence regarding whether their rights and interests in the MBS they purchase will be respected and, consequently, that their investments will be safe and secure.
- My last observation is a Catch-22. For private label MBS financing to attract more investors willing to invest at attractively priced levels, the asset class needs to be larger and more liquid. But in order to attract more investors, the asset class first needs a larger critical mass, so investors will see the value in dedicating resources to analyze and monitor the sector.

The Current Private MBS Market

The mortgage loans that are currently being securitized through our platform are probably more similar than many perceive to the loans currently being guaranteed by the GSEs, except for the average loan amount, as noted in the table below.

Loan Characteristics for First Half 2013 Business Volume		
	Redwood's Platform	Fannie Mae
Average:		
Interest Rate	3.85%	3.55%
Loan Amount	$800,000	$208,234
FICO	772	756
Loan-to-Value (LTV) Ratio	66%	75%

The GSEs have done a very good job of building loan quality. A large percentage of the loans currently guaranteed by the GSEs would meet Redwood's guidelines and, while our primary focus has been on the prime jumbo mortgage market, we are prepared to securitize prime loans of any size if the conforming loan limits are reduced.

We believe that if and when the conforming loan limits are lowered, both banks and securitization sponsors will step in to finance loans above the lowered limits at affordable rates, and the typical jumbo loan characteristics will increasingly resemble conforming loan characteristics. As for credit quality, the credit performance of our post-crisis securitizations has been stellar. No investor in the senior securities has incurred a credit loss and currently we have only one loan that is more than 60 days delinquent.

Interest rates to borrowers on conforming versus jumbo loans are narrowing closer to historical norms. On September 25, 2013, Redwood was purchasing prime 30-year fixed-rate jumbo mortgages within a rate of 4.875 percent. This compares to Wells Fargo's prime 30-year fixed-rate Agency conforming rate of 4.375 percent for the same date. The spread between these two rates of 0.50 percent is about 0.25 percentage points higher than the historical average. That also represents a dramatic improvement from the 2.00 percentage point spread that was in effect at the peak of the financial crisis in 2008. The current spread is solid evidence that private capital will provide borrowers with loans on reasonable terms if investors are presented with well-structured securitizations that also have a proper alignment of interests between the sponsor and the senior investors.

How To Build a Robust Private MBS Market

Focus on Investor Concerns

Investors are the single most critical variable to consider as you take steps to promote a robust private MBS market. Simply put, investors have the money, and without their participation, there is no market. Many potential senior MBS investors, who previously had significant asset allocations to invest in private MBS, now have little or no participation at all. This is unfortunate because the financial world has ample liquidity and investors are combing through different asset classes in search of safe, attractive yields. On a relative value basis, there is no logical reason why private MBS should not play a much larger role as an attractive investment class, as it was in the past.

So how is confidence restored among investors? Broadly speaking, I believe we need to first address investors' demands for better risk mitigation, transparency, and alignment of interests throughout the mortgage chain. Redwood's transactions prove that it can be done. We have listened to investors and worked hard to meet their new requirements for investing in private MBS by putting together transactions that included comprehensive disclosures, better and simpler structures, new enforcement mechanisms for representations and warranties, and skin in the game.

Correct MBS Structural Deficiencies and Conflicts

The private market will have difficulty growing at the velocity needed without the combined efforts of market participants, Congress, and regulators to correct structural deficiencies and conflicts in securitizations. It is critical that we strengthen the structural foundation that supports securitization so that investor protections are given greater emphasis. In traditional securitization structures, investors have relied on a trustee and a servicer to administer a securitization. The governing documents have not always addressed or contemplated all of the potential situations that could face the servicer or trustee, nor have they always provided an investor-friendly mechanism for initiating and resolving disputes. The following recommendations will correct the structural deficiencies and conflicts:

- Establish best practices in representations and warranties and other key securitization terms through the creation of a Private Market Advisory Committee (with investors holding a majority of the membership) that is given responsibility for developing new best practice standards. The standards would not be mandatory, but each securitization would be required to clearly disclose any variation from the standards.

In many cases, representations and warranties have been weak and inconsistent and have been difficult for investors to compare from one sponsor to another and from one transaction to another. In addition, it has been costly or difficult to enforce the originator's or sponsor's obligations to repurchase loans where there has been a breach. We believe the representations and warranties now required by the GSEs serve as a strong benchmark.

- Establish binding arbitration as a minimum standard for dispute resolution of representation and warranty claim disputes in private label MBS.

The Agencies are large and powerful institutions that have the ability to effectively enforce representation and warranty claims relating to loans they purchase and guarantee. In the private label MBS sector, however, there has not been a comparable force behind the enforcement of representation and warranty claims. Some originators have resisted or stalled the process for legitimate claims, resulting in costly litigation. These circumstances have led to deep investor mistrust. Furthermore, investors unable to rely on this protection have fled the securitization market and continue to sit on the sidelines. In order to correct this problem, we recommend requiring a formal dispute resolution process for ensuring enforcement—specifically, a binding arbitration standard. New best practice standards for representations and warranties, coupled with binding arbitration, would provide investors with assurance that any allegation of a violation of representations and warranties will be thoroughly investigated and pursued in an efficient manner.

- Require that securitization trusts create the position of Credit Risk Manager to manage representation and warranty claims and monitor servicer performance and actions.

The Credit Risk Manager (CRM) would be an independent third-party unaffiliated with any interest in the transaction and would have two primary responsibilities. The first would be to identify, investigate, and pursue claims for breaches of representations and warranties. This is important in the event the senior investors and the party that owns the first loss security disagree on whether or not to pursue a claim. The second responsibility would be to conduct ongoing surveillance of the servicer's activities and report to the trustee and investors the results of the review. Although a servicer is engaged to service mortgage loans in a securitization pool for the benefit of the investors, the investors have no real way of ensuring that the servicer is performing its duties because no independent review or quality control of the servicer's decisions currently exists. The securitization documentation should provide for the CRM to have the same access to loan information and original loan files as the servicer to ensure that the CRM has the information necessary to perform its responsibilities.

- Establish clear and objective uniform standards governing the responsibilities and performance of a servicer in its role as a fiduciary of the trust.

When we focus on the role of servicers in the securitization structure, we note they have sometimes been placed in the position of having to interpret vague contractual language, ambiguous requirements, and conflicting directions. In their role, they are required to operate in the best interest of the securitization trust and not in the interest of any particular bond investor. In practice, without any clear guidance or requirements, they invariably anger one party or another when there are disagreements over what is and is not allowed—with the result of discouraging some senior investors from further investment in private MBS.

- Prevent servicer conflicts of interest by prohibiting the owner of a second lien mortgage from being the servicer of the first lien mortgage on the same property.

Currently, most second lien mortgage loans are owned by the same banks that perform servicing on the homeowner's first lien mortgage. Because these banks generally do not own the first lien mortgage they are servicing, they have a strong incentive to place their financial interests as a second lien holder ahead of first lien investors when taking actions as servicer on behalf of a securitization trust. For example, a servicer could refuse to approve a loan modification or a short sale that would benefit both the first lien mortgage holder and homeowner, because doing so would directly harm their financial interest as the owner of the second lien mortgage loan.

Fortunately, there is a simple fix to this problem. Simply prohibit the owner of a second lien mortgage from operating as the servicer of the first lien mortgage on the same property. Servicing a delinquent loan is a nuanced, complicated process and investors must believe that their servicers are acting as honest agents throughout. No amount of disclosure or other half-measures will alleviate these concerns. The only meaningful solution is to definitively break the economic link between first lien mortgage servicers and second lien mortgage holders.

- Establish servicer performance triggers to serve as benchmarks and as an objective means for possible removal of the servicer.

Servicers need to live up to servicing performance standards and triggers should be established to give investors the ability to hold servicers to these standards. The triggers, which could be set by the Private Market Advisory Committee I proposed above, might include, among other things, average loss severity, adherence to foreclosure timelines, and average REO liquidation timelines. The triggers should be reviewed on a periodic basis. If a servicer fails a trigger, servicing could be terminated. Mechanisms must be established to facilitate collective action by investors when a trigger event occurs and there is a failure on the part of the trustee to take action.

- Control the systemic and loan level risks relating to second lien mortgages by giving first lien holders the ability to require their consent to a second lien if the combined loan to value (CLTV) with all other liens will exceed 80 percent.

During the housing bubble, homeowners extracted record levels of home equity through second lien loans. Second lien loans also acted as a substitute for cash downpayments to purchase houses. At the peak in 2006, these loans totaled $430 billion.

The rise of home equity lending increased the monthly payment obligations for borrowers and reduced the amount of equity remaining in their homes, leaving borrowers vulnerable to home price declines. As a result, 38 percent of the borrowers who used these loans found themselves underwater (or owing more than the value of their houses), compared to only 18 percent of those who did not. Even for well-underwritten, prime loans, the presence of a second lien correlated with increased defaults by as much as 114 percent.

The rise of second liens has had another, less-widely understood effect: it substantially increased losses for investors and chilled their interest in investing in newly issued MBS. To understand why, it is necessary to understand how investors evaluate mortgage loans. While a borrower's credit report, income verification, and other underwriting factors are important to investors in evaluating credit risk, perhaps the most important factor is the amount of a borrower's equity, or the borrower's downpayment. The amount of a borrower's equity is probably the most predictive factor of a borrower's future performance: borrowers with 20 percent or more equity have lower default rates, while those with no equity are quicker to default and walk away from their home.

Second liens undermine an investor's ability to analyze risk by making downpayment information unreliable. Imagine this scenario: a borrower applies for a first mortgage with a 40 percent downpayment—this is a loan that would historically have very low default risk. As a result, the borrower is offered a great loan at a low rate. One week after taking out the loan, the borrower takes out a second mortgage from a different lender for the remaining 40 percent of the property value. The borrower no longer has any equity and the default risk and potential loss severity on the first lien is higher than before. This is not a fantasy scenario: approximately

70 percent of borrowers in prime, privately securitized mortgages issued between 2004 and 2007 took out second liens subsequent to obtaining a first mortgage.

This level of uncertainty has a highly consequential impact on how investors assess mortgage related investments. Since investors have no way of knowing which borrowers will cash out their equity, they must assume that everyone will. This uncertainty leads private investors to demand higher rates in return for the increased risk, and the cost of home ownership goes up for everyone.

We believe that placing some reasonable restrictions on the origination of second lien mortgages will restore investor confidence and speed the transition of the mortgage market away from taxpayer exposure. We propose that first lien holders have the ability to require their consent to a second lien if the combined loan to value (CLTV) with all other liens will exceed 80 percent. If the consent is not given, then the borrower can still obtain a home equity loan, but will need to refinance the first mortgage (and pay off the first lien holder) using a standard cash-out refinance loan product. This proposal would allow borrowers to tap into their equity, while preserving a level of protection for investors in first liens. This new restriction is intended only to protect first-lien lenders, and investors, from excessive equity being extracted later, without their knowledge or consent.

- The Government should begin to reduce its participation in the mortgage market, gradually and at a measured pace by reducing the conforming loan limits.

For many years prior to the financial crisis, the Government mortgage market (GSEs, Federal Housing Administration, and Veterans Administration) and the private mortgage market have coexisted to serve the needs of borrowers. In the aftermath of the financial crisis, the Government's share of the mortgage market has increased to approximately 90 percent. If the conforming loan limits are reduced, I believe the private market would aggressively compete for those loans that exceed the new limit without any market disruption, similar to when the temporary increase in the conforming loan limit (from $625,500 to $729,750) was allowed to expire in September 2011.

- Remove the uncertainty caused by unfinished regulations.

The incomplete status of regulations required by the Dodd-Frank Act has constrained the development and growth of the private MBS market. Markets require certainty about the rules of operation so that regulatory compliance can be assured. Investors will continue to be cautious about entering the private MBS market out of concern that final regulations might soon turn a good business decision into a bad one. Markets typically manage to adapt to new regulations and continue operating under the new rules. The private label MBS market is no different.

Conclusion

The U.S. mortgage market is a complex system with many parts and key participants. Each plays a supportive role in creating a highly liquid and efficient market. The private MBS market will once again assume a major role, alongside the Government supported sector, as the issues I have discussed begin to get resolved. Thank you.

PREPARED STATEMENT OF JOHN GIDMAN

PRESIDENT, ASSOCIATION OF INSTITUTIONAL INVESTORS

OCTOBER 1, 2013

Chairman Johnson, Ranking Member Crapo, Members of the Committee, thank you for inviting me to testify here today in support of your overall efforts toward housing finance reform and specifically regarding fundamentals of a functioning private label mortgage backed securities (PLS) market.

My name is John Gidman. I am an Executive Vice President of Loomis, Sayles & Company in Boston, Massachusetts, and am testifying here today in my role as President of the Association of Institutional INVESTORS (the Association). The Association is an organization of some of the oldest and largest institutional investment advisors in the United States. All our firms have a fiduciary duty to put our clients' interests first. Put simply, it's not our money.

Our member firms manage investments for more than 80,000 pension plans, 401(k)s, and mutual funds on behalf of more than 100 million workers and retirees. Our clients include companies and labor unions, public and private pension plans, mutual funds, and families who depend on us to help them provide for their retirements, to have funds available to educate family members, and to support their financial aspirations.

Our clients are able to rely on us to prudently manage their investments in part due to the fiduciary duty we owe these organizations and individuals. We recognize the significance of this role and my testimony today is intended to reflect not just the views of the Association but the financial interests of the companies, labor unions, municipalities, workers, and retirees we ultimately serve.

We recognize the vital role robust housing finance markets play in our society. These markets traditionally provided generations of families, across a variety of income levels, pathways to gain home ownership. For decades, this defined the American Dream. Much of this mortgage financing has ultimately been provided by pension plans, 401(k)s, and similar funds whose investors valued collateralized income. Through these investment mechanisms, workers and retirees relied on the strength and depth of these markets to provide them income they needed for retirement.

Lessons Learned From the Housing Crisis

Institutional investors, like all participants in the mortgage market, have learned many lessons from the financial crisis. We learned that the stress of high unemployment and the decline in housing prices exposed certain structural weaknesses in the securitization framework.

We recognize the critical role trustees play in the functioning of PLS mortgage markets but believe that they were not and are still not legally compelled, nor financially incented, to appropriately safeguard the interests of the trusts they represent.

We are keenly aware that the incentives of the originator and the buyer of the risk were not and are still not aligned, because the originator typically sells all, or nearly all, of their economic interest in the securitization. This is a fundamental difference from other securitization markets, such as automobile or credit card markets, where the issuer retains significant first-loss risk and has very strong incentives to underwrite conservatively.

Institutional investors see that documentation was not and still is not standardized and that the strength of representations and warranties varies depending on the issuer.

Institutional investors also consider that the enforcement of existing contracts was and is still weak, particularly where vertically integrated financial institutions often serve as issuers, trustees, originators, and servicers, creating conflicts of interests and incentives not to identify deficiencies that harm investors' trusts.

As a result of these structural weaknesses, little has improved in legacy residential mortgage backed securities (RMBS) reporting, enforcement of representations and warranties, or oversight of servicer performance. A typical monthly report today for legacy RMBS securities is not transparent as to who is servicing the loans, on what basis particular actions were taken by the servicer, or even regarding reconciling cash that came in and out of the trust. Recently, large portions of the legacy RMBS market have also seen servicing duties transferred from one firm to another, without investor consent or effective challenges from trustees, even in situations where investors would have likely been opposed to such a change.

Overview of the Current PLS Market

The absolute volumes of new issuances remain a very small fraction of what they were before the 2008 crisis. However, today, the quality of the collateral underlying the PLS market has generally improved. New issue RMBS markets have reopened as of 2011, and grew in 2012 and 2013, but with issuances primarily in the "Jumbo Prime" space, or high credit quality loan balances well above the conforming limits.

The fundamental structural and process weaknesses for nonagency RMBS securitization have not been fixed in the current PLS market. The issuance process itself is very opaque. Ratings continue to be shopped, issuers are still incentivized to water down representations and warranties, and continued variability in structures and documentation make the market more challenging for investors and raise the costs of funding.

Additional uncertainty has also been added to the market due to concerns that make it harder for investors to price risk, which consequently makes it harder for investors to justify investing in the sector. Included among the factors increasing uncertainty are: (a) the potential use of eminent domain by local governments to seize mortgages held in interstate trusts; (b) assignee liability; and (c) settlements, such as the Department of Justice's and various States Attorneys General settlement—the National Mortgage Settlement—using PLS trusts' funds to remedy allegations of inappropriate, unlawful, or illegal behavior on behalf of the issuer or servicer—behavior in which investors had no role.

We do not believe that the PLS market is robust enough, given the current structural risks, to sustainably absorb significantly more supply, especially if the supply includes deals with lower subordination levels or collateralized by loans from borrowers with less pristine credit and lower downpayments (higher loan-to-value ratios). In other words, we are talking now about the vast gulf between home mortgages averaging between $250,000 to $300,000, supported by the agencies, and those for homes over $1,000,000 owned by borrowers with pristine credit and high equity.

Buy-and-hold institutional investors will either require much higher yields—yields that are likely to render credit unavailable to those middle-class borrowers most in need of it—or will likely not participate in sufficient size to support the market without significant structural reforms.

Current PLS Market Borrowing Characteristics and Loan Level Data

As I alluded to, from a credit perspective, the types of loans currently being securitized are of a very high quality. Typically, the loans have a 66 percent average loan-to-value and a 760 average FICO score, with very few second liens and no mortgage insurance, so borrowers have 20–50 percent equity in the property. In the majority of deals, only the senior (typically AAA-rated) part of the securitization is being sold, so the amount of risk being taken by the private market is relatively small. The average home price of the mortgages being securitized is over $1,000,000. These high prices, combined with large downpayments and very high credit quality, has led to a situation where the current PLS standards cannot be used to finance mortgages for the majority of Americans. It should be noted that the PLS market did provide loans of average and even below-average credit quality before the crisis and there is likely funding available to do so, if investors become convinced that the issues exposed by the financial crisis have been addressed.

The following table shows the volume and average credit characteristics of Jumbo Prime issuance from 2011 through 2013.

	2011	2012	2013 YTD
Total original Pool Balance	670,664,551	3,882,196,475	10,349,236,597
# of Pools	2	11	25
Avg. Loan Balance	885,781	875,280	796,488
Avg. FICO	773	770	768
Avg. Loan-to-Value	59.7	66.0	65.7
Avg. Combined Loan-to-Value	63.5	67.5	67.0
Full Doc (%)	100.0	100.0	100.0
Debt-to-Income	28.6	30.6	30.1
Primary Residence (%)	94.7	93.4	94.2
Purchase (%)	37.6	41.0	35.1
Source: KBRA Rating service, as of 9/15/2013			
Note - average statistics are calculated as straight-average by pool			

There is also a need for continued access to robust loan level data. Prior to the crisis, investors did receive some loan level data for RMBS. Today, data for new issue deals contains more information and more accurately represents credit risks. However, we do not have access to the actual loan documents. We believe that full access to actual loan documents is important and this data should not be restricted by requiring the use of expensive commercial data services. Immediate, free access to the actual loan documents should be reasonable, as the documents are readily available and investors in the trust legally own the documents as owners of the loans. However, even with complete data sets or access to the loan documents, we believe our information will never be as perfect as the originators' information. To level the playing field and promote an open and transparent market, we believe other factors, such the creation of a fiduciary duty for trustees, better quality reporting, and standardized representations and warranties are more important to investors than loan-level data.

General Thoughts on Housing Reform

While the PLS market has improved since the financial crisis, in our view, meaningful regulatory and operational changes must be made before the market can fully recover. Institutional investors want to be able to invest in the mortgage sector, on behalf of our clients, as the credit quality of newly originated mortgages has improved. However, as fiduciaries, we cannot put our investors' savings and assets at risk in bonds that have a significant and unquantifiable downside risk.

Therefore, we fully support Congress' efforts to reform the mortgage market. In doing so, we believe Congress should consider the agency market and the PLS market as part of one interconnected mortgage finance system. We believe that any regulation or legislation that reforms one market needs to consider the impact on the other market. Today, institutional investors favor investing in the agency market because there are fewer unknowns and many of the key investor concerns are mitigated when dealing with that market. The PLS market can redevelop, but the private market's reliance on the Government-sponsored enterprises (GSEs) will not organically decrease unless there are safeguards put in place to protect the PLS market.

S.1217, the Housing Finance Reform and Taxpayer Protection Act, which was introduced earlier this year by Senators Bob Corker (R-TN) and Mark Warner (D-VA), and is cosponsored by six other bipartisan Members of the Senate Banking Committee, addresses some of the Association's concerns and generally we think this legislation moved the debate in the right direction.

The bill's risk-sharing mechanism offers a promising solution that we believe could work if investors' need for a fiduciary standard for trustees is mandated. In July 2013, Freddie Mac issued the first risk-sharing deal in the RMBS market, called STACR 2013-DN1. We believe it was a positive sign that institutional investors were willing to take subordinate credit positions on this portfolio of agency mortgages, indicating that institutional investors may also be willing to take on risk under a Corker-Warner system.

The legislation also provides helpful language to address investor concerns with the PLS market regarding issues like standardization of documentation and enforcing representations and warranties. Title II, Subtitle C of S.1217, in particular, reflects many of the transparency and oversight principles that we believe are vital to increasing investor confidence in the mortgage market. We appreciate the inclusion of these provisions and hope they are part of any other GSE reform legislation considered by the Committee.

S.1217, however, did not address several fundamental investor concerns. These issues include: (1) creating a fiduciary duty for trustees and servicers; (2) addressing the assignee liability provisions included in Section 1413 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), now implemented by the Consumer Financial Protection Bureau (CFPB) in its Ability-to-Repay Rulemaking; and (3) limiting the ability of local municipalities to use eminent domain to seize residential mortgages held in trusts across State lines. Some of these concerns were highlighted by the crisis; others have arisen since the crisis. Each must be addressed by any mortgage market reform package that progresses through Congress, if one of the goals of the legislation is to incentivize private capital to return to the PLS market and stay in times of market stress. Each of these issues is addressed below.

Fiduciary Duty for Trustees and Servicers

Investor confidence is a foundation of the PLS market, therefore investors should have proper recourse to the parties. However, since the financial crisis began, a failure in the structure of the PLS market has been apparent: trustees do not have a regulated fiduciary duty to bondholders.

To address these concerns and create better investor confidence, any mortgage market reform legislation should include trustee fiduciary duties to oversee the maintenance of trusts and enforce put-back obligations for faulty loans with regulatory oversight and private causes of action for breaches.

Recent developments have underscored the lack of trustee fiduciary duty as the ongoing critical gap in the PLS marketplace. Situations like last year's Attorneys General mortgage servicing settlement (the AG Settlement), where investors were not involved in the negotiations, and when faced with a significant conflict of interest, trustees and servicers were able to sacrifice the assets of trust investors in favor of their own bottom line. Without a clear fiduciary duty for trustees, trustees and servicers are incented to act as they did under the settlement. Servicers have overwhelmingly favored writing down loans owned by private PLS pension and fund investors rather than writing down principal on loans owned by the banks.

The AG Settlement, while unprecedented, is also not an isolated example of a situation where trustees or servicers act in their financial interest rather than in the best interests of investors. Recently, for example, there have been media reports that a large vertically integrated bank may settle an $11 billion deal with State and Federal regulators related to investigations into the bank's sale of RMBS that were packed with bad loans. This amount reportedly would include $4 billion in relief for struggling homeowners, similar to the AG Settlement, and it is not clear at this point whether this settlement would allow that bank again to meet its obligations by using funds from PLS trusts. Like the AG Settlement, investors have not been involved in the negotiations, and if the settlement allows it, that bank would be incented to meet at least part of its obligations with trusts' assets, therefore assets of American savers, because no one has a fiduciary duty to act in the best interests of the trusts' investors—in effect, the $4 billion would be paid by American workers and retirees out of their pension assets.

Implementing a fiduciary duty for trustees would also spur further investment in the market, because investors would be assured that the trustee was acting in the best interests of the trusts' investors and incentives were properly aligned. Further, a fiduciary standard would improve the quality of trusts, as only good mortgages would be placed into the trusts, and mitigate conflicts of interest for situations where the same entity serves as both servicer and trustee.

In addition to incentivizing private capital to return because investors' rights would be better protected, creating a fiduciary duty would also reduce the incentives that currently exist to invest with the GSEs. Under the current model, the GSEs are often more attractive because they are partners to their own contracts. Investing with the GSEs ensures that an entity, the GSE, has proper recourse if there is a problem. By creating a fiduciary duty, private capital will be encouraged to continue investing in the PLS market, ultimately increasing the market share for the private market and reducing the Government footprint.

Assignee Liability

We believe that assignee liability once implemented and as currently defined in regulation will lead institutional investors to avoid the PLS market.

The Dodd-Frank Act and the CFPB's subsequent regulations create a path for a defaulting borrower to sue the lender for irresponsible lending. We agree with this principle and believe that it is good to hold originators accountable for predatory lending. However, the statute and regulations also create assignee liability, which essentially means that if the originator sells the loan, the buyer of the loan can be sued even though they were not the lender that made the bad loan in the first place. In the case of the PLS market, the trustee for the transaction would be the lawsuit target, and any legal, settlement, and damage costs would come out of collateral cash flows.

Such lawsuits are also not limited to the loan amount. Rather, potential damages awarded against the PLS trust, as the assignee, could equal to the sum of all finance charges and fees paid by the borrower (up to 3 years' worth from the origination of the loan), plus actual damages, court costs, and attorneys' fees. We expect that damage awards could amount to thousands of dollars per loan, and a typical RMBS bond includes thousands of loans. Thus, an investor could face millions of dollars in losses from this liability on each bond. Furthermore, as trusts often have the ability to pay more than small originators, we believe that assignee liability could actually have the unintended consequence of weakening the liability of the originator, because plaintiffs' attorneys will focus the lawsuits on the entity with the deepest pockets.

Given this potential liability, assignee liability risk may already be affecting the PLS market, even in advance of the CFPB's ability-to-repay requirements going into effect in January 2014. Institutional investors in this market are not close enough to the origination process to determine for themselves if all loans are exactly as advertised at the time of purchase, and so institutional investors are not willing to take on the risk that they could be sued for others' actions. Further, although Dodd-Frank and the CFPB's regulations include a safe harbor for a certain subset of qualified mortgages (QMs), this does not assuage our concerns because even if the safe harbor qualifications are met, asset managers will be forced to expend resources to establish the applicability of the safe harbor in every case where the borrower asserts that the ability-to-repay requirements were violated, regardless of the merits of the claim. Unless legislative changes are made, we expect that the PLS market will deteriorate further once these rules go into effect in January.

To address these concerns, we are supportive of any efforts to reduce the risk of assignee liability under Dodd-Frank and the CFPB regulations and to increase access to the ability-to-repay safe harbor. The best way to accomplish this goal would be by including language to eliminate assignee liability completely. Removing assignee liability would not reduce the protections afforded homeowners under the ability-to-repay provisions, but rather would ensure that only those that are responsible for generating the loans will be held accountable for the loans that they generate. Under such a system, incentives will be properly aligned and institutional investors would not be held responsible for the bad acts of other players. Alternatively, although less ideal, the legislation could include a provision that would ensure that the CFPB must expand its ability-to-repay regulations to allow more loans to meet the conclusive safe harbor standard.

Eminent Domain

It seems in every crisis, there are powerful and well-connected opportunists that prey again on the victims. Certain jurisdictions are considering implementing a program designed and aggressively marketed by a private fund whereby a city would rent out its local eminent domain power to seize performing high quality mortgage loans, held in interstate trusts, in order to restructure the mortgages at a profit for the city and the fund's investors. This unprecedented and misguided use of local eminent domain power could hurt the retirement savings of workers and retirees from across the United States, who currently invest in mortgages that would be seized, and significantly damage the overall PLS market.

Under the fund's plan, cities would seize current performing mortgages that are in trusts held by pension plans, 401(k) plans and mutual funds across the United States and managed by our members. If mortgages are taken by eminent domain, we will take action to protect the assets of our clients.

As fiduciaries, we have a duty to ensure that the investments we make on behalf of our clients are in their best interests. Therefore, after eminent domain is used, we will be forced to weigh the possibility that future mortgage contracts will not be upheld and our clients will lose value in their investments. Ultimately, we believe it will be difficult to continue investing in the mortgage markets if any local community uses eminent domain to seize assets out of interstate trusts.

Given these concerns, the Association believes any GSE reform legislation should include language similar to the language in H.R. 2733, the Defending American Taxpayers from Abusive Government Takings Act of 2013, which was included in the PATH Act (H.R. 2767). These provisions would prohibit the GSEs from purchasing, the Federal Housing Administration from insuring, and the Department of Veterans Affairs from guaranteeing, making, or insuring, a mortgage that is secured by a residence or residential structure located in a jurisdiction where eminent domain has been used to take a residential mortgage. We are also in favor of expanding the Home Affordable Refinance Program (HARP) to homeowners whose mortgages are held in PLS trusts, to provide these homeowners with relief.

Conclusion

As the Committee continues to consider housing finance reform, we hope our perspectives support your efforts. Each of our suggestions is intended to help promote a vibrant secondary mortgage market, accomplish your goal of reducing the Government footprint in the mortgage market, and avoid adverse consequences that will ultimately affect the millions of American investors who rely on the continued vitality of these markets in order to save for their families' needs. We thank the Committee for its continued work and for focusing on this difficult issue. As the Committee progresses in its work, we stand ready to provide information and assistance as a voice for the millions of Americans who rely on these markets.

Thank you for the opportunity to participate in today's hearing.

PREPARED STATEMENT OF ADAM J. LEVITIN

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OCTOBER 1, 2013

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Written Testimony of

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Before the
Senate Committee on Banking, Housing, and Urban Affairs

"Housing Finance Reform: Fundamentals of a Functioning Private Label Mortgage Backed Securities Market"

October 1, 2013
10:00 am
538 Dirksen Senate Office Building

Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in structured finance, consumer finance, bankruptcy, contracts, and commercial law. Housing finance and securitization is a major focus of his scholarship.

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Professor Levitin currently chairs the Mortgage Committee of the Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholar's Medal.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

EXECUTIVE SUMMARY

1. *PLS can only provide the financing for at most an eighth of the US housing market's peak annual financing needs.* There is a role for PLS within the US housing finance system, but it is not realistic to expect PLS to provide a significant share of the housing finance system because there is insufficient capital markets demand for credit risk on US mortgages. At best, PLS will be able to support no more than $500 billion of annual housing finance; the US housing finance market needs anywhere between $1.5 trillion and $4 trillion in annual financing, depending on interest rate conditions.

2. *PLS is a "lemons" market in which investors cannot adequately gauge the quality of the underlying mortgages.* The institutional structure of the PLS market frustrates investors' ability to make sure that securitized mortgages conform to the represented underwriting quality. Standard market discipline mechanisms such as specialized subordinated debt investors and reputational sanctions did not work in the PLS market, and it is unlikely that investors will rapidly return to this market.

3. *The "Resurrected" PLS market consists of a very small number of deals involving ultra-prime mortgages.* PLS has provided financing for only around 17,000 mortgages since 2008—fewer mortgages than originated in the District of Columbia alone last year. The mortgages financed through PLS averaged 65% LTV on properties valued at $1.26 million, and the average borrower FICO score was 723.

4. *The PLS market will not produce widely available, affordable 30-year fixed rate mortgages or provide pre-closing rate-locks.* Private mortgage markets have never produced widely available long-term, fixed-rate mortgages or pre-closing rate locks anywhere in the developed world. To the extent that 30-year fixed rate mortgages are available in the private-label jumbo mortgage market it is not on the same terms as in the Agency market. Similarly pre-closing rate-locks are available on jumbo mortgages only because the jumbo market can hedge the risk in the Agency MBS forward contract market.

5. *A PLS-based housing finance market poses serious systemic risk.* PLS will result in geographic price discrimination as investors attempt to price credit risk. Geographic price discrimination can result in self-fulfilling predictions of housing price bubbles, and the flightiness of capital from PLS markets means that capital will not be available precisely at the times it is most needed.

6. *There are several steps that can be taken to improve the PLS market, but PLS will never be able to support more than a small fraction of the US housing market.* Investor trust in the PLS market can be improved through reforms regarding securitization contract standardization, the duties and compensation of trustees and servicers, representations and warranties, ratings agencies, and the diligence process.

An appendix contains some suggested improvements to S.1217, the "Housing Finance Reform and Taxpayer Protection Act of 2013" or "Corker-Warner" bill.

Mr. Chairman Johnson, Ranking Member Crapo, Members of the Committee:

Good morning. Thank you for inviting me to testify at this hearing on private-label mortgage-backed securities ("PLS"). My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in structured finance, consumer finance, bankruptcy, and commercial law. I also chair the Mortgage Committee of the Consumer Financial Protection Bureau's Consumer Advisory Board and am a member of the Mortgage Finance Working Group sponsored by the Center for American Progress, which has put forth a proposal for GSE reform. I am here today, however, as an academic who has written extensively on housing finance and am not testifying on behalf of the CFPB, the Consumer Advisory Board, or the Mortgage Finance Working Group.

My written testimony today goes into depth regarding the limitations of PLS to provide the financing for American's homes. There is a place for PLS within the US housing finance system, but the bottom line of my testimony is that it is unrealistic to expect PLS to ever provide more than a small fraction of the capital necessary to finance the US housing finance system. There are reforms that can and should be done to improve the PLS market, but even with these improvements, PLS will remain incapable of providing more than about an eighth of America's housing finance needs. It is not realistic to rely on the PLS market to create a stable housing finance system that serves the needs of all Americans.

Instead, a reform program along the lines of that proposed by S.1217, the "Housing Finance and Taxpayer Protection Act of 2013" or "Corker-Warner bill", that features private first-loss capital backstopped by an explicit, and priced, federal guarantee, should be the basic model for rebuilding the housing finance system. There are important technical challenges and trade-offs in the details of such a reform program, and I suggest some possible improvements to S.1217 in an appendix, but the basic point should not be lost: PLS cannot be the foundation of the US housing finance system.

I. PLS OVERVIEW

A. Interest Risk Versus Credit Risk Investors

Mortgage investment entails two principal types of risk: interest rate risk and credit risk. Credit risk is the risk that the borrower will default on the mortgage. Interest rate risk is the risk that interest rates will either rise—in which case the interest rate the investor earns on the mortgage will be below market—or that interest rates will fall—in which case the mortgage will now be at an above market rate, but with the borrower likely to refinance.

The mortgage securitization market can be roughly divided into two types of securitizations based on their allocation of interest rate and credit risk: GSE and Ginnie Mae securities ("Agency MBS") and private-label mortgage-backed securities ("PLS").

Agency MBS divide the credit risk from the interest rate risk. Investors in Agency MBS assume interest rate risk, but not credit risk. The credit risk is retained by Fannie, Freddie, or Ginnie, which often are insured for part or all of that risk, either through private mortgage insurers or through FHA insurance and VA guarantees.

In contrast, investors in PLS assume both interest rate risk *and* credit risk. Nonetheless, while in the past PLS investors formally assumed credit risk, few thought that they were assuming more than *de minimis* credit risk. Typically, both credit and interest rate risk are not spread evenly among investors in PLS, but are instead allocated in a senior-subordinate tranching structure, with senior tranches assuming less risk and therefore receiving lower coupons than the riskier junior tranches. The overwhelming majority of PLS were rated AAA at issuance. In most PLS deals over 90% of the securities were initially rated AAA, with another perhaps 5% receiving lower investment grade ratings, and no more than 5% of the securities receiving non-investment grade ratings or not receiving a rating.

Investors who relied on these ratings understood the credit risk on these PLS to be negligible because of the quality of the underlying mortgages and various credit enhancements to the PLS, such as the senior-subordinate credit tranching, overcollateralization, excess spread accounts, and various types of insurance.

Indeed, the overwhelming majority of investors in the U.S. secondary mortgage market are not credit risk investors. Investors in Agency MBS are not credit risk investors, and most investors in PLS did not perceive themselves as assuming credit risk. Instead, most investors in the U.S. mortgage market are interest rate risk investors; PLS were an attractive asset class during the run up to the financial crisis because they were AAA-rated, yet had slightly higher yields than Treasuries, and were far more readily available than AAA-rated corporate securities. Thus, as Goldman Sachs CEO Lloyd Blankfein has noted, "In January 2008, there were 12 triple A-rated companies in the world. At the same time, there were 64,000 structured finance instruments . . . rated triple A."[1] Thus, there is approximately $6 trillion in interest-rate-risk-only investment in the US mortgage market.

Interest rate risk investors are very different types of investors than credit risk investors. Investing in credit risk successfully requires a different kind of diligence and expertise than interest rate risk investment. A large portion of the investment in U.S. mortgages is from foreign investors.[2] Middle Eastern sovereign wealth funds and Norwegian municipal pension plans, for example, are unlikely to seek to assume credit risk on mortgages in a consumer credit market they do not know intimately. But interest rate risk is something that foreign investors are far better positioned to assume because it is highly correlated with expectations about U.S. Federal Reserve discount rates. Indeed, it is hard to conceive how a foreign pension plan or even say a Wisconsin school teachers' retirement fund could undertake meaningful diligence of mortgage underwriting practices.

B. The Rise and Fall of the PLS Market

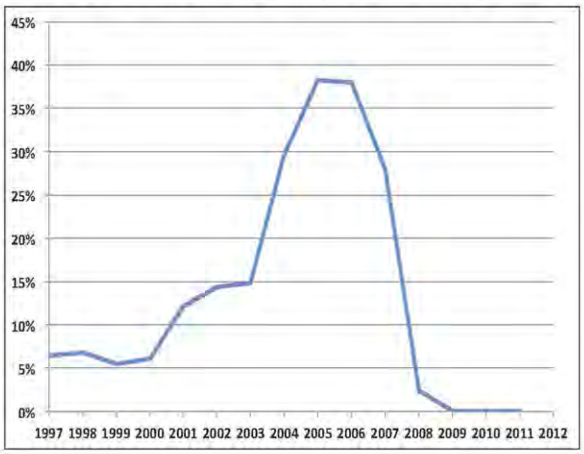
PLS have existed since 1977, but were a small part of the housing finance market for many years. The PLS market began to take off in the mid-1990s following the S&L crisis as the risks of balance-sheet lending were better understood. By the mid 1990s, PLS were financing roughly twenty percent of the US housing finance system by dollar amount. At this point PLS was being used primarily to finance prime "jumbo" mortgages that were too large to meet the GSEs' and FHA's conforming loan limits, but also some subprime loans that failed to meet the GSEs' credit quality requirements.

[1] See Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FIN. TIMES, Feb. 8, 2009, at 7.

[2] Ben S. Bernanke et al., *International Capital Flows and Returns to Safe Assets in the United States, 2003-2007*, Board of Governors of the Federal Reserve System International Finance Discussion Papers Number 1014, February 2011.

Starting in 2001, the share of subprime within the PLS market began to grow, becoming a majority of PLS by 2004,[3] when the PLS market took off as it provided the kerosene that fueled the housing bubble.[4] As Figure 1, below, shows, at its peak in 2005-2006, the PLS market provided the financing for 38% of mortgage lending (by dollar amount).[5] By 2008, however the PLS market had retreated to virtual non-existence.

Figure 1. PLS Share of Mortgage Originations Finance by Dollar Amount[6]



C. The PLS "Resurrection": Financing a Handful of $1.26 Million Homes

The PLS market has made a very modest recovery since 2008. As of September 26, 2013, there have been only 33 post-crisis PLS deals, accounting for a mere $15.3 billion in housing finance.[7] These 33 deals provided financing for only 16,778 mortgages.[8] By comparison, there were over 8.6 million mortgages financed nationwide in 2012 alone.[9] In other words, PLS is financing far less than 1% of the US mortgage market.

[3] Inside Mortgage Finance, Mortgage Market Statistical Annual.

[4] Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1252-58 (2012); Adam J. Levitin & Susan M. Wachter, *Why Housing?* 23 HOUSING POL'Y DEBATE, 5 (2013).

[5] Inside Mortgage Finance, Mortgage Market Statistical Annual. PLS accounted for 56% of securitization at peak in 2006, but securitization volumes were only two-thirds of total mortgage origination volumes in 2005-2006.

[6] Inside Mortgage Finance, Mortgage Market Statistical Annual. The chart graphs the quotient of PLS issuance (excluding re-REMICs) over mortgage origination volume.

[7] Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (9-19-13).

[8] *Id.*

[9] HMDA

The average home financed with these PLS mortgages was worth $1.26 million or nearly 5 times the median price of a new home sale in August 2013.[10] The average mortgage size in these deals was nearly $825,000,[11] over four times the national average.[12] These deals were backed by ultra-prime collateral: the average loan-to-value (LTV) ratio on these deals was 65%, and only 0.5% of the mortgages had an LTV of above 80%.[13] In other words, these were very high down-payment mortgages—typically 35% down.

Borrowers had pristine credit and clear ability to repay: borrower front-end debt-to-income (DTI) ratios averaged 30%; the average borrower's FICO (credit) score was 723 out of 850, a prime credit score; and all the mortgages were fully documented.[14]

Since 2008, then, the PLS market has provided financing to an exceedingly small number of super-low risk mortgages on extremely high value homes. This generates little confidence that the PLS market can be successfully expanded in the foreseeable future to support even 1% of the US housing finance market. Even if PLS were to return to it pre-bubble levels, it could not finance more than an eighth of peak US housing finance market capital needs.

II. A LEMONS MARKET: THE INSTITUTIONAL MECHANICS OF WHY THE PLS MARKET COLLAPSED

To understand why the PLS market collapsed, it is necessary to understand how the institutional and contractual structure of PLS facilitated poor mortgage underwriting and misrepresentation of loan quality to investors, if not outright fraud, resulting in credit losses even for investors who thought they had not assumed any real credit risk. The result has been a complete loss of trust between buy-side investors and the sell-side financial institutions in PLS. Restoring the investor trust necessary to revive the PLS market will, at the very least, require regulatory intervention to mandate standard minimum investor protections.

A. The Basic PLS Transaction

The basic, stripped-down PLS transaction involves a financial institution (the "sponsor") assembling a pool of mortgages loans that it either made itself or purchased. The pool of loans is transferred to a special purpose subsidiary of the sponsor (the "depositor"), and then the depositor transfers the loans to a trust that is legally independent from the sponsor and depositor. Legal title to the loans is then held by a trustee, while the trust engages an agent called a servicer to manage the loans. The trust pays the depositor for the loans by issuing securities, which the depositor then transfers to its securities affiliate for sale to investors following rating by credit rating agencies. Those securities are the private-label mortgage-backed securities ("PLS").

The various rights and obligations of sponsors, depositors, servicers, trustees, and investors are set forth in what is typically a single transactional document, known as a pooling and servicing agreement ("PSA"). Some securitizations, however, split the transaction into

[10] http://www.bloomberg.com/news/2013-08-27/home-prices-in-20-u-s-cities-increased-at-slower-pace-in-june.html.

[11] Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (9-19-13).

[12] http://www.fhfa.gov/webfiles/15882/avg_loan_size_2010Q2.csv (average loan sizes for GSE loans—most of the market).

[13] Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (9-19-13).

[14] *Id.*

multiple documents, which might not be simultaneously executed. While the basic contours of PSAs tend to be similar, there is actually substantial variation among PSAs, including in: representations and warranties, putback requirements, servicing requirements and limitations, and investor collective action thresholds. This variation can exist even with a single "shelf" from the same sponsor.

The loans are transferred from sponsor to depositor and from depositor to trust with a set of representations and warranties about the quality and characteristics of the loans. The remedy for a representation or warranty violation is specified in PSAs as a "put back"—the return of the non-conforming mortgage to the depositor in exchange for either a conforming loan or the principal and accrued interest outstanding on the loan. The loans are otherwise transferred without recourse.

B. Servicers

The actual management of the mortgage loans for the trust is handled by an entity called a "servicer." The servicer is responsible for collecting payments on loans, managing defaulted mortgage loans and real estate owned, and enforcing the representations and warranties made about the loans by the sponsor and depositor to the trust. Servicers are often (although not always) affiliates of the sponsor/depositor. This means that servicers are tasked with enforcing representations and warranty violations by their affiliates through putbacks.

Servicers are compensated with a percentage of the outstanding principal balance on each loan, the "float" on the funds they collect before remitting them to the trust, and any other fees they are able to collect from borrowers (such as late fees or modification fees).[15] These fees get paid off the top of collections, before any funds are paid to the PLS investors. Because servicers are paid off the top of collections, they are not incentivized to maximize recoveries for the trust. Thus, servicers might prefer to pursue a foreclosure instead of a loan modification if the foreclosure results in immediate cashflows sufficient to cover its compensation, despite a modification being better for PLS investors overall. Similarly, a servicer has little incentive to ensure that a foreclosure sale brings in a price higher than necessary to cover its own costs. While servicing is unlikely to change the likelihood of default in most cases, it has a major impact on loss given default.[16]

Servicers are also charged with guaranteeing a certain level of liquidity to the trust by "advancing" payments on delinquent mortgages to the trust to the extent that recovery of the advances is reasonably foreseeable. These advances are reimbursable from other collections, but without interest. The lack of interest and the liquidity strain of advances on servicers strongly disincentivizes them from making advances, despite a contractual obligation to do so.

Servicers may also have conflicts of interest with the trust because they may themselves (or through affiliates) hold junior mortgages on the properties on which the trust holds the senior mortgage. Thus, the servicer is both an agent of the trust and a competing creditor to the trust.

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[15] For a fuller description of servicer compensation and incentives, see Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1 (2011).

[16] Samuel Krueger, *The Effect of Mortgage Securitization on Foreclosure and Modification*, working paper, June 2013, *at* http://scholar.harvard.edu/files/skruger/files/securitization_and_foreclosure.pdf.

This situation can incentivize a servicer to encourage borrowers to pay on the junior mortgage it holds instead of on the senior one held by the trust.

C. Trustees

Legal title to the mortgage loans transferred to the trust is held by a trustee. The trustee is generally one of a handful of large financial institutions that specialize in corporate trust work. Trustees are selected by the securitization sponsors, not by the PLS investors, and most PLS sponsors have a "preferred trustee" that receives most of their business.

PLS trustees receive minimal compensation—typically 1 basis point (.01%) or less on the outstanding principal balance of the loans. Given this low level of compensation, it is should not be surprising that PLS trustees believe that they have extremely limited ministerial duties prior to an event of default under the trust documents, such as a failure of a servicer to perform its contractual obligations. PLS trustees also believe that they have no duty to take notice of an event of default absent notification and indemnification by investors holding 25% of the voting rights of the PLS.

In other words, prior to notification of an event of default, these PLS trustees do not believe themselves to have any fiduciary obligations to the PLS investors. After an event of default, PLS trustees are tasked with acting in accordance with a prudent person standard, but because PLS investor lists are not public, even notifying a PLS trustee of an event of default is difficult.

Investors, moreover, lack ready access to the information necessary to determine if an event of default has occurred: the information about whether a servicer is meeting its contractual obligations regarding putbacks or advancing or prudently servicing loans is all in the hands of the servicer. The trustee could obtain this information, but trustees believe that they are under no duty to do so prior to an event of default. Thus, before PLS investors are able to spur a trustee to take action to protect their interests, they face the challenge of limited information available on which to determine if an event of default has occurred, the information problem of identifying other PLS investors in their deal, the collective action problem of coordinating the required threshold of PLS investors (who do not always have identical incentives and may trade in and out of their positions), and the expense of indemnifying the trustee.

The result is that PLS trustees are not motivated to be vigorous advocates for the rights of PLS investors. PLS trustees are unlikely to press servicers to diligently pursue putback claims for representation and warranty violations, to maximize recoveries on defaulted mortgages (either through smart modifications or by maximizing foreclosure sale returns), or to fulfill advancing obligations.

D. No One's Minding the Store

Thus, while PLS trustees are supposed to oversee servicers, and servicers are supposed to oversee representations and warranties about the loans, the trustees are poorly motivated to oversee the servicers who are in turn poorly incentivized to prosecute violations of representations and warranties and who have incentives to take actions against the interest of the PLS investors. PLS investors, then, are entrusting their funds to agents (the trustee and servicer) who lack the proper incentives to protect the PLS investors' interest and whom the PLS investors cannot easily discipline.

Given this situation, sponsors know that it is unlikely that they will be accountable for the representations and warranties they make about the loans they securitize. This in turn incentivizes sponsors to securitize loans of lower quality than represented and warranted. In other words, sponsors can knowingly or negligently sell grade B loans as grade A loans and collect a grade A price for the grade B loans because they know that they are unlikely to have to pay damages for breach of contract. The entire design of PLS encourages lack of care in underwriting, if not outright fraud.

E. Limitations of Subordinated Debt ("B-Piece") Investors to Provide Credit Diligence

Absent adequate internal contractual protections (or regulation), there were only two real bulwarks against misrepresentation and fraud: diligence by subordinated debt investors and the reputational risk to sponsors. The economics of securitization are such that it is not profitable unless both the senior AAA-rated tranches (the "A-piece") and the junior non-investment grade or unrated tranches (the "B-piece") can be sold. While there was always significant demand for the A-piece because of the virtually unlimited market appetite for AAA-rated assets (especially those with higher yields than Treasuries) selling the B-piece was more difficult, and had to be done first.

Traditionally, there was a small, but sophisticated cohort of B-piece investors specialized in analyzing credit risk. These B-piece investors paid for access to loan tapes prior to deal closing and received "kickout" rights to remove mortgages that they did not like from the pools in which they invested. Prior to roughly 2004 it was not possible to sell a securitization that these traditional B-piece investors would not buy. The A-piece investors were thus able to piggyback on the diligence of the B-piece investors. Starting in roughly 2004, traditional B-piece investors began to be outbid for the B-piece by collateralized debt obligations ("CDOs"). CDO managers were not specialists in mortgage credit risk, but were simply looking to maximize their assets under management on which their compensation was based.[17]

The disappearance of the CDO market may help return B-piece investors as a check on credit quality in PLS, but also indicates that there is a definite ceiling to the potential size of the PLS market. One can use 2003 as a (generous) cutoff year to isolate out CDO-financed PLS from traditional B-piece buyer financed PLS. Using this cutoff indicates that traditional subordinated investors were never able to provide the credit risk assumption for more $300 billion annually in housing finance in a market that has needed an average of about $2.5 *trillion* in new investment, and as high as $4 trillion in some years. Even optimistically assuming that the PLS market could provide $500 billion in annual investment, this means that it is simply unrealistic to expect even a restored PLS market to be able to provide much more than a eighth of peak US housing finance needs and on average no more than a fifth.

F. Reputational Sanctions Do Not Work in the Modern Financial Services World

Reputational sanctions are unlikely to work in the modern financial services world. The reputation on the line is that of the PLS sponsors—institutional entities—but the gains from misrepresentation or fraud accrue to individual employees of those institutions in the form of immediate compensation. As these employees have very moveable human capital and are not linked to the long-term reputation of an institution, it is unclear whether reputational sanctions

[17] MICHAEL LEWIS, THE BIG SHORT 142-43 (2010) (describing the incentives of Wing Chao, the largest CDO manager).

are sufficient to ensure the quality of securitized mortgages. Thus, a recent study by the Center for Public Integrity found that senior executives from all of the 25 top subprime lenders during 2005-2007 were back in the mortgage business as of 2013.[18] Similarly, it is easy enough to move from the securitization desk of a failed investment bank to another or to an investment fund. The lack of SEC and DOJ prosecution of either individuals or institutions related to pre-2008 PLS merely underscores the lack of consequences of securitizing non-complying mortgages. Thus, it is unlikely that reputational sanctions are sufficient to keep the PLS market in check.

G. PLS Are a Lemons Market

Given these circumstances, it should not be surprising that investors have been incredibly reluctant to return to the PLS market. Once burned, they are twice shy. The PLS market is the very incarnation of Nobel Prize winning economist George Akerloff's famous *Market for Lemons.*[19] And as Akerloff predicted would happen in a lemons market, the market collapsed because of lack of buyer confidence.

If investors are to return to the PLS market they will need to be confident that the mortgages backing the PLS are actually of the quality and characteristics promised and that if they are not, their warranty rights will be enforced. Ensuring that representations and warranties are vigorously enforced is necessary to ensure initial underwriting and documentation quality.

To ensure enforcement of investor rights requires reform of trustee compensation and duties, of servicing contracts, of diligence procedures, and of credit rating agencies. None of these are simple tasks. Increasing trustee duties, for example, will necessitate increasing trustee compensation, and that will result in higher mortgage costs. To the extent that PLS compete with other forms of mortgage financing, this will make PLS a less competitive financing execution.

III. THERE IS NO EVIDENCE THAT PLS CAN SUPPORT MORE THAN AN EIGHTH TO A QUARTER OF THE US HOUSING FINANCE MARKET'S CAPITAL NEEDS

A. The PLS Market Has Never Supported More Than a Fraction of America's Housing Finance Needs

Based on the historical experience with PLS, it is unrealistic to expect PLS to be able to support more than a (generously optimistic) $500 billion in annual investment in a US housing finance market that requires as much as $4 trillion in annual investment (typical annual financing needs are more in the range of $2 trillion). There is no evidence that there is a substantial body of capital eager to assume this much credit risk on U.S. mortgages *at any interest rate*, much less at rates that would not make mortgages prohibitively expensive for borrowers. Even if private-label MBS were structured to remove most credit risk from some securities (thereby concentrating it in others), few investors are likely to trust credit ratings on MBS in the foreseeable future.

[18] *See* Daniel Wagner, *Subprime Lending Execs Back in Business Five Years After Crash*, CENTER FOR PUBLIC INTEGRITY, Sept. 11, 2013, *at* http://www.publicintegrity.org/2013/09/11/13327/subprime-lending-execs-back-business-five-years-after-crash.

[19] George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

B. The Jumbo Market Does Not Provide Evidence of the Viability of a Large-Scale PLS Market

Mortgages that are too large to qualify for purchase by the GSEs because of the statutory conforming loan limit are known as "jumbo" mortgages. There is a private securitization market in jumbo mortgages. In the jumbo market, investors assume both interest risk and credit risk. Advocates of privatization often claim that the existence of the jumbo market is proof that a securitization market can function without a government guarantee. This argument ignores the small size of the jumbo market and the numerous ways in which it piggybacks on the Agency MBS market. In fact, the jumbo market indicates that there is a quite limited demand of credit risk on U.S. mortgages, and certainly not enough to sustain the entire market absent a government guarantee.

The jumbo market overall is substantially smaller than the conforming market. The jumbo market overall is only perhaps 10-15% of all originations by either volume or dollar amount. In 2011, there were $203 billion in jumbo originations, when the entire market was $1.35 trillion in originations. This figure is roughly in keeping with pre-2008 ratios, and jumbos have never been more than a quarter of the total market.

What's more, the securitization rate for jumbo loans is substantially lower, which has resulted in a much smaller amount of jumbo mortgage-backed securities issued than GSE MBS. Jumbos' lower securitization rate is itself strong evidence of limited capital market investor demand for credit risk on U.S. mortgages—at least at interest rates less than those borne on subprime loans.

The prime jumbo market does function without a government guarantee, but it also benefits from the existence of a government guarantee indirectly in multiple ways. For example, jumbo portfolio lenders hedge their interest rate risk by investing in GSE securities.[20] Advance rate lock-ins on jumbos are available because jumbo lenders can largely hedge their rate risk using the conforming To Be Announced ("TBA") forward contract market. The jumbo market has also long aped the standards set by the GSEs in the conforming market, including amortization, maturity lengths, and appraisal standards. Finally, the jumbo market has benefitted from stability in housing prices and overall systemic stability created by the government guarantee in the conforming market given the serial correlation of housing prices. Indeed, the virtual disappearance of the jumbo market following the financial collapse in 2008 draws into question whether this market is in fact viable; the spillover benefits from the guarantee in the conforming market have not been enough to resuscitate the jumbo market.

All the existence of the jumbo market demonstrates is that there are *some* investors who are willing to assume credit risk on U.S. mortgages. It does not provide evidence that the PLS market can develop on sufficient scale to be the mainstay of the US housing finance system.

IV. THE PLS MARKET PRODUCES RISKIER MORTGAGES

A. The PLS Market Will Not Produce Widely Available 30-Year Fixed Rate Mortgages

Privatization advocates also claim that the presence of jumbo 30-year fixed rate mortgages ("FRMs") demonstrates that a private market will continue to produce 30-year

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[20] Frank E. Nothaft, *Lessons from the Jumbo Market*, 1996 Mortgage Market Trends 12 (1996).

FRMs.[21] This is a strawman argument. No one claims that the 30-year FRM will entirely disappear with privatization. Instead, privatization will turn it into a niche product that is not widely available to American families.

The fully prepayable 30-year fixed-rate mortgage is a uniquely American and uniquely consumer friendly product that furthers economic stability and monetary policy. The 30-year FRM is the crown jewel of the American housing finance system. Its long amortization period lowers mandatory monthly payments. The fixed rate shields households from inflation and facilitates stabile household budgeting. The ability to prepay enables consumers to take advantage of improved rate environments and to pay down the mortgage faster if they have excess funds. And the prepayment feature greatly facilitates Federal Reserve monetary policy by enabling lower interest rates to easily translate into greater disposable income for consumers and increased consumer spending in the real economy. 30-year FRMs underwritten with full documentation did not blow up in the housing bubble. Any restructuring of the system should start with the question of how to ensure the widespread availability of the 30-year FRM.

History indicates that the private market will not produce 30-year FRMs in any volume. Long-term fixed-rate mortgages were virtually unheard of in the United States prior to the federal government's entrance into the housing finance market during the New Deal. Instead, the pre-New Deal private market produced short-term "bullet loans"—non-amortized, interest-only 3-5 year FRMs that had to be frequently rolled-over before the "bullet payment" of the entire principal came due. If the borrower's credit quality declined, if interest rates had increased, or if the market was frozen, the borrower had to bite the bullet and come up with the cash to pay off the entire principal.

This sort of bullet loan structure is exactly what the private-label securitization market returned to during the bubble years: loans with short 2-5 year teaser rates, sometimes interest-only or even negatively amortizing, before a major rate reset. These loans were expected to refinanced before the rate reset. We know the result.

Indeed, overall, the PLS market has a definite bias toward ARMs and away from FRMs. From 2001-2008, 70% of all loans originated for PLS were adjustable-rate. In comparison, only 12% of loans originated for GSE securitization during this same period were adjustable-rate.[22]

Similarly, the fully private commercial mortgage market—which operates using both portfolio lending and securitization—rarely produces fully-amortized 30-year FRMs. Instead, the standard commercial mortgage product is a 10-year interest-only loan. Prepayment penalties or yield-maintenance clauses are common, and it is rare to find fixed-rates for commercial loans of periods beyond 10 years. Left to its own devices the private market eschews long-term fixed-rate loans.

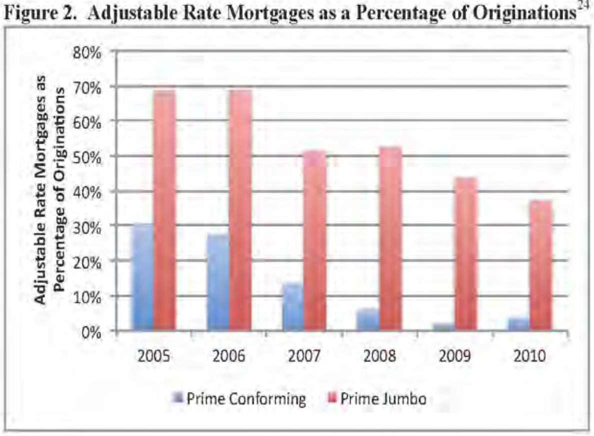
The jumbo market does produce 30-year FRMs. But it only produces a very small number of them. Jumbos are only a small percentage of the market overall, and only a minority of jumbos are FRMs, and not all of those are 30-year maturities. Even in the extreme low-rate

[21] *See, e.g.*, Testimony before the Senate Banking Committee, Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute (Mar. 2013) (noting that there are Google results for the search "30-year jumbo fixed rate mortgage.")

[22] FHFA, *Data on the Risk Characteristics and Performance of Single-Family Mortgages Originated from 2001 through 2008 and Financed in the Secondary Market* 3 (2010); David Min, *How Government Guarantees in Housing Finance Promote Stability*, 50 HARV. J. LEG. 437, 482 (2013).

environment of 2009-2010, over a third of jumbos were adjustable rate mortgages ("ARMs"), compared with less than 5% of prime conforming loans. As Figure 1, below, shows, the jumbo market (Prime jumbos) contains a considerably higher percentage of ARMs than the GSE market (Prime Conforming). The private jumbo market simply does not produce very many 30-year FRMs. In fact, in recent years jumbo FRMs have been only 4% of the entire mortgage market. 30-year jumbo FRMs may be advertised on websites, as privatization proponents have noted,[23] but in practice they are rare. The existence of a small number of FRMs in the relatively small jumbo market is not a basis for assuming that the market will produce 30-year FRMs on any scale absent a government guarantee.

Figure 2. Adjustable Rate Mortgages as a Percentage of Originations[24]



B. A PLS Market Will Make It Impossible for Homebuyers to Lock in Rates in Advance

One of the marvels of the US housing finance market is the ability of homebuyers to lock in rates as much as 90 days prior to closing. This is a feature that is unheard of elsewhere in world. The ability to lock in rates in advance is a considerable benefit to both buyers and sellers. It allows buyers to be pre-qualified for a mortgage and thus know in advance how much they are able to spend on a home purchase. This certainty allows sellers to maximize sale prices because prices do not need to be discounted for the uncertainty of financing rates. The result is to enhance the liquidity of the US housing market and boost housing prices accordingly.

Homebuyers are able to lock in rates in advance because lenders are able to do so themselves by selling advance commitments in the form of forward contracts on the "To-Be-Announced" ("TBA") market. The TBA market is a market of forward contracts in MBS. The TBA market exists only for GSE MBS; jumbos and other private-label MBS do not trade in the

[23] *See* Wallison, *supra* note 21.

[24] Emanuel Moench, James Vickery, & Diego Aragon, *Why Is the Market Share of Adjustable Rate Mortgages So Low?* 16 CURRENT ISSUES IN ECON. & FIN. 1, 3 (Fed. Reserve Bank of N.Y. 2010).

TBA market.[25] Thus, to the extent that a borrower can lock in a jumbo rate in advance, the lender must assume the rate risk in this duration. Lenders are willing to do so in part because they can largely hedge the rate risk on the jumbo through offsetting sales in the TBA market.

The TBA market is able to function because the GSEs' MBS are exempt from the registration requirements of the federal securities laws. Because the TBA market involves the sale of MBS *before the MBS have been created*, it is impossible for those MBS to be registered with the SEC.[26] Even with a registration exemption, however, a TBA market is not possible for PLS because they lack the high degree of fungibility that exists between GSE MBS, which is necessary as an economic matter to create a liquid forward contract market. There is variation among the GSE securities that trade in the TBA market, but they also all share three key features that help homogenize the GSE MBS: (1) all credit risk is held by the GSEs; (2) all are pass-through securities; and the (3) geographic composition of the pools cannot be determined by investors. The variations among GSE MBS that trade TBA are relatively minor.

A PLS market cannot support a TBA market, so relying solely on PLS would make it extremely difficult for borrowers to lock in mortgage rates 60-90 days before closing. Credit risk on PLS is held by PLS investors and would vary in part based on the financial strength of the issuer that makes the representations and warranties about the quality of the securitized mortgages. As a result, these securities are very likely to be structured to create credit enhancement, rather than pass-throughs. Structuring would destroy fungibility, as the credit enhancements would vary between individual MBS. And because investors would bear credit risk, they would demand to know information such as geographic composition of pools, as they already do for private-label MBS. Indeed, one of the factors the Kroll Bond Rating Agency explicitly lists as affecting their rating of PLS is the geographic composition of the mortgage pools.[27] Pre-closing rate-locks would not be standard in a PLS-financed system.

C. The PLS Market Will Produce Geographic Price Discrimination and Systemic Risk

The GSEs do not currently disclose the geographic make up of their pools pre-sale, and this prevents geographic price discrimination—there is no premium paid for living in parts of the country that are perceived of as riskier, either in terms of credit risk or in terms of prepayment risk (such as states with greater population mobility). Instead, in our current housing finance system, there is geographic cross-subsidization. In a PLS market, this cross-subsidization would disappear, with the likely result that the South and West would face higher mortgage rates, just as they did before the entry of the federal government into the housing finance market. Rural communities would also likely face higher credit costs.

Whatever one thinks of the distributional fairness of cross-subsidies, there is good reason to support its continuation, as it helps reduce systemic risk. Geographic price discrimination can result in self-fulfilling predictions of local housing bubbles and foster instability in the financial system.

For example, if there is a state budget crisis in Illinois (an all too real prospect), that could be expected to raise the costs of mortgage credit in Illinois, because state budget cuts could

[25] So-called "conforming jumbos" or "high balance" conforming loans have traded in the TBA market since 2008, after the conforming loan limits were temporarily raised under the Economic Stimulus Act of 2008, but these loans are guaranteed by the GSEs and should not be confused with traditional Jumbos.

[26] 12 U.S.C. § 1455(g) (Freddie Mac exemption); 12 U.S.C. 1717(c) (Fannie Mae exemption).

[27] Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (9-19-13).

affect local housing values. Higher costs of credit would depress Illinois housing prices, which would in turn raise default rates and result in yet higher cost so mortgage credit in Illinois, creating a vicious cycle. Thus, it would be easy for local housing price collapses to be spurred by largely unrelated events, and there is a risk of a cascade across local markets. What's more, the flightiness of capital from PLS markets—as illustrated by the PLS market's precipitous collapse in 2008—means that the capital necessary to support housing prices will not be available precisely at the times it is most needed.

V. Potential Reforms of PLS and Their Limitations

A. *Experiments in Recent PLS Deal Structures: One Step Forward, One Step Back*

The PLS deals issued since 2008 have begun to experiment with deal design, reflecting, in part, some of the learning going on in the commercial mortgage securitization market, which has rebounded more successfully that the PLS market (although CMBS is only back to around 25% of its 2007 peak), under the auspices of a separate trade association.[28] I will refer to these post-2008 PLS deals as "PLS 2.0."

PLS deal structures are one step forward, one step backward, and for fundamental issues simply treading water. Often improvements in some areas are offset by regression in others. Thus, Moody's Investor Services noted that JPMorgan Mortgage Trust (JPMMT) 2013-1 PLS would not likely achieve a AAA rating despite having "strong originators, provides better data than pre-crisis deals, and the collateral consists of high quality loans with low loan-to-value ratios (LTVs) and high borrower credit scores" because "the transaction has a weak representations and warranties (R&W) framework coupled with a restrictive enforcement mechanism. In addition, neither JPM nor any of its affiliates are retaining any credit risk and JPM is holding all the collateral files for the loans in the pool."[29]

Among the improvements in PLS 2.0 are provisions regarding access to investor lists[30] and directing trustees to take notice of breaches of originator representations and warranties without direction from investors.[31] Particularly significant is the introduction in the Sequoia deals of a party called the "Controlling Holder," which is required to engage a third-party to undertake a review of all loans that are 120 days delinquent for breaches of originator representation and warranties.[32] This third party cannot have conducted the pre-securitization review of the loans.[33] The Trustee is then charged with pursuing breaches of originator

[28] The CMBS market is represented by the Commercial Real Estate Finance Council, while the PLS market has the American Securitization Forum representing the sell side, and, more recently the Association of Mortgage Investors representing the buy side.

[29] Moody's Investor Service, *New JP Morgan RMBS Has Structural Weaknesses, Falls Short of AAA*, Mar. 25, 2013, *at* https://www.moodys.com/research/Moodys-New-JP-Morgan-RMBS-has-structural-weaknesses-falls-short--PR_269473.

[30] E.g., SEMT-2013-8, ¶ 8.02.

[31] E.g., SEMT-2012-5, ¶ 2.05(a)(ii).

[32] E.g., SEMT-2012-5, ¶ 2.05(b). This is most likely not a structure that banks can easily replicate because the combination of control and upside/downside risk means that the entire securitization should remain on balance sheet under SFAS 166, thereby vitiating the regulatory capital relief benefit of securitization, as risk based capital charges take GAAP-based balance sheets as their starting point.

[33] *Id.*

representations and warranties.[34] This structure at first glance seems well designed to enforce the *originators'* representations and warranties, but its effectiveness is mitigated by the requirement that putbacks to being done on a loan-by-loan basis,[35] rather than through a sampling methodology, as has been approved by courts. Moreover, the controlling holder is *not* a fiduciary,[36] and other investors are not given any explicit rights in regard to the controlling holder, so if the controlling holder fails to fulfill its obligations, it is unclear what recourse investors have against it.

As I read the relevant PSAs, moreover, the Controlling Holder provisions relate only to prosecuting representations and warranties by originators, not by sellers or depositors. This is particularly concerning because the Controlling Holder is an affiliate of the sponsor and the depositor. Only the Trustee (chosen by the sponsor) is charged with handling sponsor/depositor breaches of representations and warranties, but the Trustee is only authorized to do so upon receiving notice of a breach…and that notice may only come from the sponsor or depositor. In other words, the sponsor and depositor representations are solely on the honor system.

Some PLS 2.0 provisions are downright regressive. Instead of requiring 25% of all votes in a deal to make a demand on the trustee to act, PLS 2.0 deals are requiring 25% of the votes in *each* tranche.[37] This makes it near impossible for investors to make a demand on the trustee to act; a single investor in a single tranche can block enforcement. Given that the deal sponsor's affiliate is the holder of the junior tranche, this means that enforcement will only happen if the deal's sponsor wants it to; other investors are at the sponsor's mercy. The prohibition on sampling for putbacks is similarly regressive. What appears to be occurring in PLS 2.0 is that investors are given formal rights, but then presented with procedural obstacles to enforcing them. It would be all too easy for most investors never to notice this until after they're invested.

Most troubling with PLS 2.0 is that there is no change in the way trustees and servicers are selected, in their duties, or in their compensation. PLS 2.0 has shown some willingness to experiment, but none of the changes are likely to restore investor trust in PLS as an asset class. More work needs to be done to restart the PLS market.

B. Potential Reforms of the PLS Market

There are several possible reforms that could be undertaken to increase investor trust in the PLS market. First, PLS would benefit from greater standardization ranging from loan underwriting and documentation practices to aggregation and securitization practices to securitization documentation to securitization structures. Promoting such standardization should be a goal of any housing finance reform bill, as standardization will make the housing finance market more liquid and also facilitate investor diligence.[38]

Heterogeneity among PLS deals makes it difficult for investors to compare. If deals differed on say five dimensions, it would be far easier for investors to evaluate the relative risks of deals than if they varied on five hundred dimensions. There is no reason why boilerplate language should vary among securitization documents, and minimum investor protections should

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[34] *Id.*

[35] SEMT 2013-1, ¶ 2.04(a).

[36] E.g., SEMT 2012-5, ¶ 2.07(b).

[37] SEMT 2013-8, ¶ 6.18.

[38] Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1252-58 (2012).

be standardized so investors can count on a baseline of protections in all deals. Proposals like that in S.1217 regarding uniform securitization agreements are an important step in the right direction.[39]

Second, and relatedly, the Trust Indenture Act of 1939 should be updated to provide clear basic minimum standards for the duties of trustees and servicers in PLS and investors rights. The Trust Indenture Act is the major legal protection for bondholders, and it governs the duties and standards applicable to indenture trustees. There is debate (and pending litigation) about whether the Trust Indenture Act currently applies to PLS. The answer may depend on the individual deal, but PLS trustees believe that in most cases it does not apply. Irrespective of whether the Trust Indenture Act currently applies to PLS, it should, although it should also be updated and revised to account for specific problems in PLS.

In particular the Trust Indenture Act should forbid trustees or whatever party is responsible for protecting the rights of PLS investors from having any conflicts of interest. This would at the very least forbid investment in PLS by the trustee or its affiliates. It should also forbid other business relationships with sponsors and depositors. The trustee or party responsible for protecting the rights of PLS investors should also be an express fiduciary to all the PLS investors. Similar requirements might be extended to servicers, and servicers should be prohibited from servicing first liens on which they or their affiliates own the junior liens.

A third possibility is to reform the role of PLS trustees. PLS trustees perform several different functions: some ministerial reporting work for the trust, enforcement of the PSA, and serving as the backup master servicer (in case of the servicer's bankruptcy). These roles could be divided. A separate trust administrator can perform the ministerial functions (and does in some PLS 1.0 deals). The backup master servicing role could be contracted out to another master servicer (and indeed, that is all most trustees would do if they had to take over the servicing). And the role of PSA enforcement could be given to a specialized enforcement party. That specialized enforcement party would not need to maintain significant standing capacity and could be paid a small regular retainer except when its duties were required, at which point it could be paid on a fee for services model.

Some of the PLS 2.0 deals take steps in this direction. The "Controlling Holder" mechanism charges the juniormost investor with retaining an independent investigator of all 120+ day delinquent loans for originator representation and warranty violations. Similarly, commercial mortgage-backed securities automatically transfer all loans that run 60 days delinquent to a special servicer chosen by the juniormost in-the-money tranche. That special servicer is compensated with a vertical slice of the loan so as to align its incentives with those of the CMBS investors as a whole.

There are problems with both of these structures, even though they are moves in the right direction. The main problem is that enforcement mechanism is controlled by a single investor that may not share the interests of the other investors. Indeed, this is a fundamental problem with tranched securitizations—investors with different interests are tied together in the same deal structure. Giving enforcement rights to one single investor sets up potential conflicts of interest, particularly when that investor is also an affiliate of the sponsor, as in the Sequoia deals. PLS

[39] S.1217, § 223.

investors cannot rely on sponsors to police themselves, and none of the PLS 2.0 structures fundamentally change the selection, duties, or compensation of the trustee.

Ultimately, changes in PLS deal structures—either by market experimentation or by regulation—might help develop trust between PLS investors and the PLS sponsors, servicers, and trustees. But these changes will not restore investor trust in credit ratings. A discussion of the problems in credit ratings is beyond the scope of my testimony today, but trust in ratings is which is necessary back the "safe" interest-rate-risk-only investors back into PLS and for AAA-rated PLS to again be accepted as collateral in repo and securities lending markets without haircuts from par. Unless both the PLS deal structures *and* the credit rating agencies are fixed, it is hard to imagine PLS ever expanding beyond the ultra-prime PLS 2.0 deals and growing to more than a marginal market share.

CONCLUSION: THE ILLUSION OF WHOLLY PRIVATE HOUSING FINANCE SYSTEMS

The government's involvement in the U.S. housing finance system carries with it serious concerns of moral hazard, socialized losses and privatized gains, and politicized underwriting. The PLS market, however, is not a solution. Despite privatization's ideological appeal, there is a fundamental problem with privatization proposals for the housing finance system: they don't work. Fully private housing finance systems simply do not exist in the developed world.

PLS are not and have never been a totally private system. To the extent that sponsors are too-big-to-fail financial institutions, their representations and warranties benefit from the implicit government guaranty. Moreover, these institutions benefitted from piggybacking on the GSE market in numerous ways

Every other developed country either explicitly or implicitly guarantees some part of its housing finance system. In some countries, like Canada, the guarantee is explicit—and priced—and the market is regulated to protect the government from excessive risk exposure. In other countries, the guarantee is implicit.[40] It is difficult to prove an implicit guarantee; the very nature

[40] Proponents of privatizing the housing finance system and eliminating the government guarantee will generally point to Germany and Denmark as examples of housing finance systems without a guarantee that have widely available long-term, fixed-rate mortgages. E.g., Peter J. Wallison, *A New Housing Finance System for the United States*, Mercatus Center Working Paper No. 11-08; *at* http://mercatus.org/sites/default/files/publication/wp1108-a-new-housing-finance-system-for-the-united-states_0.pdf, at 10 ("Neither Denmark nor Germany backs any part of the mortgage financing system, which seems to work well because of the regulatory assurances of mortgage quality."). Unfortunately, this view of the German and Danish housing finance systems is incorrect. Germany and Denmark both turn out to have been latent implicit guarantee cases prior to October 2010, at which point they became examples of explicit guarantees.

In October 2008, Germany created a Teutonic TARP known as the "Special Fund Financial Market Stabilization," or SoFFin (its German acronym) to bail out its banks. SoFFin provided nearly €150 billion to support ten financial institutions' liabilities, including those of three covered bond issuers and three Landesbanks (another type of German mortgage lender). *See* Bundesanstalt für Finanzdienstleistunsaufsicht, "Annual Report of the Federal Financial Supervisory Authority" (2008), available at http://www.bafin.de/cln_152/nn_720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport__08__complete,templateId=raw,property=publicationFile.pdf/annualreport_08_complete.pdf.

Denmark also announced a broad guarantee of all deposits and senior debt issued by its banks in October 2008. *See* Neelie Kroes, "Guarantee scheme for banks in Denmark," European Commission Memorandum, State Aid NN51/2008 – Denmark," *available at* http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf. Denmark has a robust mortgage lending system financed by covered bonds—bonds issued by banks against mortgage collateral held on balance sheet. Formally, the Danish guarantee did not apply covered bonds, only to the of it is that there is no clear proof. One can look at spreads between mortgage debt and government debt, for example, but that is not necessarily conclusive. Indeed, in the United States, GSE debt was explicitly *not* guaranteed by the federal government…until it was.

Try as we may, we cannot escape either history or the reality that the U.S. government will always bailout its housing finance system if it gets into trouble. We did that in 1932-34. We did so in 1970 by letting Fannie Mae purchase conventional mortgages and creating Freddie Mac with conventional mortgage authority. We did it with the S&Ls in the 1980s. We did it again in 2008. Catastrophic risk in housing finance is inevitably socialized, so it is best to recognize that truism and adapt our regulatory system to mitigate the risk. Pretending that it won't happen again is hardly a solution.

We do not have to like the existence of a government guarantee in housing finance. But the choice we face is between an implicit and an explicit guarantee, not between a guarantee and no guarantee. All government guarantees have clear problems—moral hazard because the government holds the credit risk, while private parties hold the upside, and the danger of politicized underwriting.

There are ways to try to guard against both problems. For example, moral hazard can be alleviated through use of deductibles and copayments—have first-loss private risk capital or loss splitting between the government and private capital. Administrative structures can guard against politicized underwriting. Those risk mitigants, however, require an explicit guarantee. I am pleased to see that this problem is well understood by S.1217, and I offer some suggested improvements to that bill below, in an appendix.

For better or worse, though, we need to accept that *some* form of a government guarantee, even if only for catastrophic losses, is required in our housing finance system. It cannot be confined to an FHA niche, but needs to be system-wide in part because of the serial correlation of housing prices and credit risk. The unique nature of housing finance as an enormous asset class that affects a wide swath of citizens and economic and social stability means that no U.S. government will permit the market's collapse: it would be economic and political suicide. The question then is not whether there should be a guarantee—we have one whether we want it or not—but how it should be structured.

I would urge this Committee to not pursue a path of housing finance reform that relies on PLS providing the backbone of the market. If housing finance reform relies on the PLS market to provide the financing for American's homes, we will witness a nationwide decline in home prices unless the PLS market somehow figures out how to generate trillions in financing that it never has previously provided.

Relying on PLS to serve as the main financing source for the housing market would be a high-risk gamble with the US economy. Instead, a hybrid public-private system with first-loss private capital backstopped by an explicit and priced government guarantee, such as that proposed by S.1217,[41] should provide the basic template for housing finance reform.

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deposits and senior debts of the banks that issued them. The functional reality of this arrangement, however, was to guarantee the covered bonds by guaranteeing that the issuers would have sufficient assets and liquidity to meet their covered bond payment obligations so that the covered bondholders would never have to look to their cover pools of collateral for recovery.

[41] S. 1217, § 204(a).

APPENDIX: SUGGESTED IMPROVEMENTS TO S.1217, THE "HOUSING FINANCE REFORM AND TAXPAYER PROTECTION ACT OF 2013"

The conceptual framework of a hybrid public-private housing finance system embodied in S.1217 is fundamentally sound. That said, there are three areas in which I would suggest some important substantive changes to S.1217, in addition to various smaller technical changes.

(1) *S.1217 should explicitly task the proposed Federal Mortgage Insurance Company (FMIC) with adopting policies aimed at ensuring specific market results regarding product availability.*

S.1217 should explicitly task the proposed Federal Mortgage Insurance Company (FMIC) with adopting policies aimed at ensuring specific market results regarding product availability. Specifically, section 201(a) of S.1217 should expressly charge the FMIC with ensuring the continued wide-spread availability of the 30-year fixed rate mortgage, pre-closing rate locks, a robust TBA market, fair access and affordability, and support for multifamily housing options.[42] FMIC should also be charged with ensuring against geographic price discrimination. It is easy to forget that housing finance is only a means of furthering housing policy. Charging FMIC with specific policy outcomes will help ensure that the market retains prized features of the existing housing finance system. Delegating authority to FMIC to figure out how to achieve these results within the statutory framework provided by S.1217 will avoid the problem of Congress attempting to draft overly restrictive statutory language for a developing market.

(2) *S.1217 should provide a more robust framework for regulating bond guarantors.*

That said, the regulatory regime for bond guarantors in S.1217 is insufficient to ensure safety-and-soundness. S.1217 would have the FMIC would license these guarantors,[43] but FMIC would have few intermediary regulatory tools short of refusing to renew a license. Tools like Prompt Corrective Action directives and the ability to levy monetary penalties and cease and desist orders have not been especially successful in the regulation of depositories, but should at least be added to FMIC's toolbox, and FMIC should have the authority to regulate bond guarantors to avoid granular risk-based pricing, prevent creaming, and ensure good reinsurance practices. Likewise, FMIC should have the express authority to clawback compensation from executives of bond guarantors that have engaged in malfeasance resulting in a loss to FMIC.

(3) *S.1217 should level the playing field between bond guarantors and capital markets.*

S.1217 contemplates the 10% first loss position being supported either by capital markets investors or by bond guarantors.[44] As currently drafted S.1217 would seem to favor capital markets as the bill seems to establish a capital requirement of 100% equity for bond guarantors' support of the 10% first loss position,[45] and requires FMIC to monitor safety and soundness of bond guarantors—albeit without all of the necessary tools, as discussed above—but not of capital

[42] Ensuring the existence of a TBA market will likely require the use of a single-security that is good delivery for obligations irrespective of the identity of the bond guarantor, if the 10% first loss position is guaranteed by a bond guarantor.

[43] S.1217, § 214.

[44] S.1217, § 202(a)(2).

[45] S.1217, § 214(a)(2).

markets issues. To the extent that capital markets executions are favored by S.1217, it would limit the capital available for PLS.

S.1217 could be improved by leveling the playing field for bond guarantors. Their capital requirements should not be different from those of issuers and should be set on the actuarially appropriate amount required for the risk, rather than at 100% equity. They should also not be subject to any sort of "stop-loss"—they should have to pay out on claims until their funds are exhausted. Likewise, the regulatory standards applied to bond guarantors should apply to all credit-risk takers, including capital markets executions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR KIRK FROM MARTIN S. HUGHES

Q.1. FHFA has taken several steps while Fannie Mae and Freddie Mac have been in conservatorship to preserve the assets and protect the taxpayers. These steps include enhancing the underwriting, credit risk pricing, and reps and warrants contracts of counterparties with Fannie Mae and Freddie Mac. These actions ensure standards being used by the two Enterprises are more updated, comprehensive, transparent, and that they more accurately reflect the risks assumed by the two Enterprises. Had these reforms been implemented prefinancial crisis much of the fraud, poor risk-management, and losses to the taxpayers could have been avoided. Going forward, these actions are providing for a more attractive and transparent agency market for investors, which is essential to ensuring the U.S. housing market continues to be attractive for global investment.

Can you tell me if the private label security (PLS) market is adopting the same stringent transparency and contractual standards as the agency market? If not, why not?

A.1. Participants in the post crisis private label security (PLS) market have implemented increased transparency and contractual standards, but with variations among the PLS sponsors. For example, it is my understanding that most or all of the issuers have adopted the American Securitization Forum disclosure format, which contains approximately 150 fields of data per loan backing a PLS. This compares to approximately 35 data fields disclosed by the Enterprises. Therefore, I would say that the PLS market provides far more data and transparency about the loans backing private securities than is currently being offered by the Enterprises. The contractual standards have also improved in the private market, but with variation among PLS sponsors. For example, some current securitization sponsors, mainly banks, have "sunset" clauses in their representation and warranties that they make to the securitization trusts, which we believe undermines confidence among the triple-A investors to purchase PLS. The PLS issued by Redwood do not have sunset provisions as we believe the PLS market needs to be held to a higher standard.

Q.2. What is holding back standardization of the PLS market? What is happening to PLS pools in the market today?

A.2. Simply stated, the lack of a self-governing organization or regulatory directed standardization is contributing to the holdback in standardization. As a result, PLS issuance represents a growing but still very small market. For example, in 2012, only $3.5 billion out of $200 billion of jumbo mortgage originations were securitized, representing less than 2 percent of originations. For the first 6 months of 2013, $8.3 billion of prime jumbo originations were securitized out of $113 billion of originations, representing 7 percent of the market. These percentages are much smaller than the period starting in 1995 through 2007 in which the percentage of jumbo loans securitized to total jumbo originations averaged 29 percent.

We believe that what is holding up the reemergence of prime PLS is a combination of structuring and monetary policy issues that currently incent large banks to retain mortgages on their balance sheets. The structuring issues that are holding up the reemergence of PLS include:

1. A need for standardized representations and warranties for all securitizations that protect investors from noncredit related losses. Any exceptions should have to be noted clearly on a schedule so that investors do not have to compare and contrast the rep's and warranties from one deal to another against a standardized format.
2. A need to have a standardized enforcement mechanism (such as binding arbitration) for rep and warranty breaches.
3. A need to empower the trustee to proactively monitor and take appropriate actions for the benefit of the security holders. We suggest the concept of the "controlling holder" as is used in our Sequoia securitizations.
4. A need for investors to have confidence that their collateral will not be unfairly taken from them through Government actions (such as through eminent domain) or by third-party mortgage servicers that do not have an economic stake in the securitizations they service by modifying loans to further their own interests.
5. A need to protect investors from having their mortgage collateral diminished in value by allowing borrowers an unlimited ability to withdraw equity from their houses. We suggest that any lender who proposes to provide a subordinate financing on a property that would increase the combined loan-to-value ratio above 80 percent obtain the consent of the first mortgage holder, and if the consent is not granted, the new lender can provide a new first mortgage for the entire amount desired.

We also believe that investors take comfort from issuers that have meaningful "skin in the game." At Redwood, for securitizations we have sponsored post crisis, we hold 100 percent of the noninvestment grade securities that are first in line to incur losses, which we believe provides a high alignment of interest with the investors in the senior securities. We realize that this issue is far more complicated than just risk retention, but it is unfortunate that it appears most residential securitizations will not require sponsors to retain risk. We expect to continue to hold all of the noninvestment grade credit risk tranches on our securitizations.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR COBURN FROM MARTIN S. HUGHES

Q.1. One component of the housing finance system that has much received significant discussion over the last year is the role of recourse available to the lender. Recourse is available to lenders on a State-by-State level. States where recourse is available to lenders have a significantly lower risk of default as comp, especially among those who may strategically default. One Federal Reserve analyst found that for a sample of loans originated between August 1997 and December 2008, "the probability of default is 32 percent higher in nonrecourse States than in recourse States." Borrowers who had a property value of $500,000–$750,000 at origination were over 100 percent more likely to default in nonrecourse States than in recourse States. In your view, would expanded availability of recourse strengthen our housing finance system? What is the impact of recourse availability on investors' decision making in real estate and private-label mortgage-backed securities?

A.1. On the subject of recourse lending, we are generally in favor of the concept and we understand that it has worked well in Canada and Australia. As a practical matter, when a lender has an option of using a nonjudicial foreclosure process that does not allow for a deficiency judgment, or a using a judicial foreclosure that provides the lender with a deficiency judgment, lenders overwhelming use the lower-cost nonjudicial foreclosure alternative. Borrowers that "strategically default," despite having ample resources, inflict damage to the integrity of the mortgage market and ultimately force all borrowers to pay a higher price for a loan, since investors suffer additional losses.

RMBS investors factor into their pricing models loss severities by loan, which is a function of where the property is located and the rules around the foreclosure processes in each State, which would take into account the ability to obtain a deficiency judgment.

Q.2. In your written testimony you said we should "remove the uncertainty caused by unfinished regulations," referring specifically to the Dodd-Frank Act. You said the incompleteness "has constrained the development and growth of the private MBS market." As you know, some proposals for the future housing finance system would place a new Federal regulator in the system in the form of the Federal Mortgage Insurance Corporation. The Federal Reserve, Department of Housing and Urban Development, Securities and Exchange Commission, Office of the Comptroller of the Currency, and Consumer Financial Protection Bureau all already manage these regulations. In your view, what are the most significant outstanding regulations impeding the industry currently? Additionally, how do you believe the future complexity of navigating regulations by these different agencies will adversely impact innovation and flexibility in the marketplace?

A.2. As of October 1, 2013, only 40 percent of the 398 rules required by Dodd-Frank have been finalized. Various unfinished rules have a greater impact on some parts of the market than others. For the mortgage securitization market, one of the key unfinished rules is the risk retention, or QRM, rule. My point is not to single out any one rule as most important, rather the weight of all the unfinished rules is stifling growth and innovation. Markets cannot grow if businesses cannot understand the rules under which they will be required to operate. Perhaps some of the rulemaking delay is the result of having such a fragmented financial regulatory system. The addition of yet another regulator should be reason enough to step back and assess the need to streamline the current regulatory infrastructure.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM JOHN GIDMAN

Q.1. Can Government guaranteed MBS with private capital first loss exposure (as described in S.1217) be structured to allow trading in the TBA market? If so, how?

A.1. The Association believes that Government guaranteed MBS with private capital first loss exposure can be structured to allow trading in the TBA market. However, in order to do so, there must be increased transparency, a fiduciary duty for servicers and trustees, and loan level disclosures.

This year, Freddie Mac successfully marketed a new product, the Freddie Mac Structured Agency Credit Risk (STACR) securities, which shows that there is an appetite and it is possible to sell first-loss pieces of certain Government guaranteed MBS into the private market. However, deals like STACR 2013-DN1 did not include any new originations, and investors were able to review the history to appropriately price the risk.

Unlike STACR 2013-DN1, under S.1217 investors are assuming the first loss position without the ability to review historical data related to the underlying collateral. In this type of scenario, increased disclosures and a fiduciary duty are necessary to attract institutional investment advisers to consider investing in the deals. Assuming increased transparency and a fiduciary duty provides institutional investors with more comfort in the quality of these investments, the Association expects these deals would be as reasonably attractive as any other subordination investment.

Also, the STACR deal had Freddie Mac taking first 0.3 percent of risk below investors, and "catastrophic" risk above the credit risk sold to investors. This created an alignment of interest between Freddie Mac and investors, with Freddie Mac having a strong economic interest to minimize losses—we think this is a very important credit consideration for investors. In a situation where all of the credit risk is sold to investors, this alignment of interests would not exist, and investors would likely demand a higher return for the increase in risk.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR KIRK FROM JOHN GIDMAN

Q.1. FHFA has taken several steps while Fannie Mae and Freddie Mac have been in conservatorship to preserve the assets and protect the taxpayers. These steps include enhancing the underwriting, credit risk pricing, and reps and warrants contracts of counterparties with Fannie Mae and Freddie Mac. These actions ensure standards being used by the two Enterprises are more updated, comprehensive, transparent, and that they more accurately reflect the risks assumed by the two Enterprises. Had these reforms been implemented prefinancial crisis much of the fraud, poor risk-management, and losses to the taxpayers could have been avoided. Going forward, these actions are providing for a more attractive and transparent agency market for investors, which is essential to ensuring the U.S. housing market continues to be attractive for global investment.

- Can you tell me if the private label security (PLS) market is adopting the same stringent transparency and contractual standards as the agency market? If not, why not?
- What is holding back standardization of the PLS market? What is happening to PLS pools in the market today?

I would love to see the conforming loan limits for agency mortgage backed securities to be lowered, as it is one of the more obvious ways to increase and incentivize the private market back into this market space. I am concerned however that if the standards in the PLS market are not the same as the agency market—including to provide for clear and updated reps and warranties agreements and greater transparency—that investors will be hesitant to move to the PLS space.

- If the standards for risk-based pricing, reps and warranties and standardization of agency securities are improved for any "agency-like" security that is developed post-housing finance reform, will investors begin demanding these enhanced standards for PLS investment? What more could be done to incentivize the private market to adopt such standards?
- Do you think that the PLS market can truly be optimized if loan limits are lowered before greater transparency, contractual, and fiduciary changes/updates are adopted in the PLS market?

A.1. *Summary*—The PLS market has not adopted the same stringent transparency and contractual standards as the agency market because institutional investors and their investment advisers are not parties to the agreements, unlike the Government-sponsored enterprises (GSEs). Without being parties to the agreements, investors have little leverage to "demand" these enhanced standards for PLS investment. Further, the parties to the agreements have no incentive to enhance the underwriting, credit risk pricing, and representations and warranties.

We believe Congress should consider the agency market and the PLS market as part of one interconnected mortgage finance system. We believe that any regulation or legislation that reforms one market needs to consider the impact on the other market.

S.1217 considers the establishment and operation of a Federal Mortgage Insurance Corporation (FMIC) as playing an important role in structural reforms designed to align interests appropriately for the various parties engaged in the housing finance markets. It may be helpful to explore ways to support expansion of this concept to the PLS market though implementation of an agency-like entity, perhaps titled the Private Mortgage Assurance Corporation, which could provide many of the structural elements we have highlighted as important components of housing reform in support of the PLS markets.

This type of private mortgage agency entity, while not providing a Federal backstop, could promote a variety of services including standards for documentation covering PSAs, representations and warrantees, enforcement mechanisms, due diligence, and identification of baselines for risk managers and servicers. Such an entity could be party to the contracts, similar to the way the GSEs are party to their contracts, and would have the authority to enforce these contracts on behalf of investors. We think this approach is better than the complex documentation and multiple levels of re-underwriting that is becoming prevalent in the PLS market, which increase costs without providing an enforcement mechanism.

The Association's members support further standardization of documentation in the PLS market, as well as efforts to increase transparency and enhance representations and warranties. These changes will ultimately help create a more level playing field. However, we do not believe standardization should be the ultimate goal. Even without standardization, if servicers and trustees had a fiduciary duty to act in the best interest of investors, the Association believes that communication and trust would increase among the parties and the market would be strengthened.

The PLS market already had loan-level data transparency, risk-based pricing, and many of the contractual protections that have come into the agency market in the past several years. However, the crisis exposed the fact that trustees are not required to enforce the documentation, and servicers (often the same banks that originated the faulty loans) are unwilling to hand over borrower credit files to be examined for Reps and Warrants breaches. In the end, investors have had very little actual success in enforcing their rights.

Rather than looking to incentivize the private market to adopt such standards, the Association believes it would be better to focus on ensuring that servicers and trustees act in the best interests of the investors. Trustees would act more rapidly and decisively to protect a trust's assets if subjected to a fiduciary duty, and they would also better oversee the activities of servicers. Further, servicers would have the proper incentives to act transparently in their servicing duties. The Association believes the PLS market cannot be optimized if loan limits are lowered before a fiduciary duty is extended to these entities.

Expanded Response—The fundamental issue across the PLS market is alignment of interests between the originator of the loans, the servicer, and the PLS investor. The simplest way to align interests (the way it is done in almost every other securitized market in the U.S., and also in most foreign mortgage markets) is for the originator to hold the subordinate position. Risk retention places the first-loss risk with the party that has the best information to evaluate that risk—the originator. It aligns the interests of the originator and PLS investor in the most straight-forward way. If risk retention is impossible, first-loss piece shifts to investors, who do not have the best information or control of the servicer. As a result, we think PLS investors need protections, such as very strict contractual protections and enforcement mechanisms.

There is little homogeneity in "to-be-announced" (TBA) pools. The agency market is liquid because of the GSEs' guarantee, not because the market or the pools have become more standardized. Therefore, the Association believes that standardization may not be the major obstacle for investors to return to the PLS market. The Association agrees that there is a marginal benefit to standardization, as it avoids fragmentation. However, despite this marginal benefit, investors would prefer that Congress focus on creating transparency and ensuring that investors' interests are being protected, rather than focusing on standardizing documentation. As long as the market is transparent and investor rights are enforced, institutional investment advisers can appropriately price the risk and buy the assets.

Transparency would be best created in a market where market participants are able to trust one another, rather than be concerned that each participant is only focused on their own best interests. To create such trust, it would also be helpful to have access to the actual loan files. Particularly when our clients are taking the first loss risk, the operational and borrower risk is documented in those loan files. Further, the Association recommends creating a fiduciary duty for trustees and servicers, which would better align interests among market participants. Such a change would best be achieved through amending the Trust Indenture Act, and specific language regarding such changes is detailed in the Association's White Paper submitted to the Committee on October 11, 2013.

The Association agrees with Senator Kirk that FHFA has been far more successful in enforcing representations and warranties than the private market. However, this is largely due to the ways in which the GSEs are able to identify, find, and enforce the repurchase of defects, rather than the difference in the underlying contracts. If PLS issuers were obligated to operate in the same fashion, investors would benefit, but it is unlikely PLS issuers will ever do so. The GSEs are able to operate as they do simply because of their market power, not because of increased standardization or better reps and warranties. If, for example, a major bank says they will not buy back loans, the GSEs could in theory shut them out of the market. Institutional investment advisers and their clients do not have this type of negotiating power.

If the standards for risk-based pricing, representations and warranties and standardization of agency securities are improved for any "agency-like" security that is developed post-housing finance reform, investors would ask for these enhanced standards to also apply to PLS investments. However, just as these requests are going unheeded in today's market, leading to a lack of new PLS pools, there would likely be no incentive for this to be created in the post-housing finance reform PLS market, unless a fiduciary duty is created for entities like trustees and servicers.

As we mentioned above, we also believe it is worth exploring creating an organization that would standardize contracts and oversee that these contracts are enforced. The Association believes this concept could be built into the FMIC common securitization platform provisions of the Corker-Warner bill, if this is the base text of the Senate Banking Committee's mortgage reform proposal. We view this proposal as additional and complementary to assigning fiduciary designation to the trustees. Such an organization could be a party to the contracts, similarly to the way the GSEs are party to their contracts, and would have the authority to enforce these contracts in the best interests of the trust.

Over the course of the Financial Crisis, because of thousands of PLS trusts (each with its own documentation) and hundreds of PLS investors, investors have found it challenging to coordinate their efforts in order to enforce their contractual rights. Often it is difficult to even determine who other investors in each trust may be, in order to reach minimum voting thresholds that would compel trustees to act. Existing trustees are typically themselves large banks, and have a multitude of relationships with the banks they are supposed to sue, causing conflicts of interest. Creating a central utility with standardized representations and warrants of underwriting quality and stringent enforcement mechanism would give all investors greater confidence to buy and give the originators the right incentives to securitize high-quality loans. This organization would also have the ability to set servicing standards and hold servicers accountable for acting legally and in the best interests of investors, something the GSEs do today but which is impossible in today's PLS market.

Originators and Wall Street firms would still originate loans, create the liability structure and control pricing execution—assets and liabilities would remain priced by the market. We think this approach is better than the complex documentation and multiple levels of re-underwriting that has become prevalent in the PLS market in the past 2 years, which increase costs without providing an enforcement mechanism. A standardized platform may also reduce pressure for banking consolidation, by making it easier for midsize investors to perform due diligence on PLS, and making it cheaper for smaller banks to sell loans into PLS trusts. If investors found such a framework attractive, they would chose to buy securities issued under these contracts, offering lower cost of funds than is available through the current structure of the PLS market.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR COBURN FROM JOHN GIDMAN

Q.1. One component of the housing finance system that has received significant discussion over the last year is the role of recourse available to the lender. Recourse is available to lenders on a State-by-State level. States where recourse is available to lenders have a significantly lower risk of default as comp, especially among those who may strategically default. One Federal Reserve analyst found that for a sample of loans originated between August 1997 and December 2008, "the probability of default is 32 percent higher in nonrecourse States than in recourse States." Borrowers who had a property value of $500,000–$750,000 at origination were over 100 percent more likely to default in nonrecourse States than in recourse States. In your view, would expanded availability of recourse strengthen our housing finance system? What is the impact of recourse availability on investors' decision making in real estate and private-label mortgage-backed securities?

A.1. *Summary*—The Association believes that to the extent that expanded availability of recourse lowers delinquencies and foreclosures, it would likely be helpful. However, in today's market, recourse is not enforced in any State, including those States where recourse is available. The Association believes that transitioning the U.S. to a full-recourse system would be very difficult, and instead efforts should be focused on ensuring that servicers and trustees use legal tools available to them today to act in the best interests of the trusts.

History of Recourse Provisions—To fully understand why the Association believes it would be nearly impossible to implement a Federal recourse[1] standard, it is helpful to consider some of the changes to the market that have been implemented since 2008, when the Federal Reserve's study cited in the question concluded. The Association agrees that prior to the crisis, the probability of default was higher in nonrecourse States. However, since the financial crisis, the public policy trend has clearly been toward weakening recourse in all States.

Much of this stems from Congress' implementation of the Home Affordable Modification Program (HAMP), which was designed to assist struggling homeowners. In order to entice servicers to work under the program, it included a servicer safe harbor, which ensured that investors and others could not sue the servicer. The HAMP program subsequently emboldened State legislatures to implement and enforce investor-unfriendly regulations. Today, not only is recourse no longer practically (and politically) enforceable, but lenders are effectively required to both allow the borrower to keep their house and forgive debt.

Given this history, any Federal deficiency regulation would have to supersede State regulations, and Federal regulators would have to ensure that each State was enforcing the requirements. Until the housing market fully recovers, we believe that this would be very difficult, and recourse provisions would likely not be enforced.

Potential Unintended Consequences of Expanded Recourse Provisions—Additionally, it is important to also consider the potential macro impacts of expanded recourse that may be less helpful to the market. Other systems, such as the housing market in Japan, have full recourse available, and it has actually harmed the system because it places too great of a burden on consumers. In practice, creating a system where there is no ability to forgive debt has led to situations where bursting asset class bubbles cause consumers to find themselves with so much debt that consumer attitudes shift against any future investment in that asset class—in this case, housing.

Impact of Recourse Availability on Investors' Decision Making—Currently, since recourse provisions are almost never enforced, institutional investment advisers assign no value to the availability of recourse. Therefore, they currently have no impact on investors' decision making.

Alternative Solutions—The Association believes there are better ways to protect investor interests than expanding the availability of recourse provisions, including creating a fiduciary duty for trustees and servicers. For example, if a fiduciary duty were imposed upon trustees and servicers in a similar manner as mutual fund or ERISA pension plan trustees, investors would have more reason to have confidence that their assets are protected because the servicer and trustee would be required to act in the investors' best interest. Additional information regarding how the Association would implement such a fiduciary duty is included in the Association's testi-

[1] In this discussion, the Association is defining "recourse" as laws that: (1) permit the lender to seize any assets that were used as collateral to secure the loan, and (2) if money is still owned after the collateral is seized and sold, then take the borrower's other assets or sue to have his or her wages garnished.

mony, as well as the Association's White Paper submitted to the Senate Banking Committee on October 11, 2013.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM ADAM J. LEVITIN

Q.1. Please detail the potential size of the market for private label MBS based on historical levels. In addition, please provide a comparison to the size of other fixed income markets.

A.1. At the peak of the PLS market in 2007, there were $2.2 trillion in PLS outstanding. Over 90 percent of those PLS were investment grade (usually AAA-rated), indicating that there has never been more than $220 billion of true credit risk investment in the PLS market. Annual PLS issuance peaked at less than $1.2 trillion in 2005. Based on this, I cannot imagine a PLS market supporting more than $500 billion in annual flows—slightly more than the annual issuance of PLS in 2002, before the housing bubble and PLS crazy took off. Correlations between flows and outstandings vary significantly, but a reasonable rule of thumb based on historical correlations is that outstandings are unlikely to be more than three times flows. Therefore, based on a peak possible flow of $500 billion, a PLS market could probably support no more than $1.5 trillion in housing finance needs. The current U.S. housing market has $11 trillion in financing needs.

Relative to U.S. fixed income markets, the PLS market has always been relatively small. There were approximately $38.1 trillion in U.S. fixed income securities outstanding as of the end of 2012. Of this $38 trillion, approximately $36.6 trillion (96 percent) of these securities—involve zero or quite limited perceived credit risk: Treasury securities; the debt of Federal agencies and GSEs; GSE MBS; money market instruments; investment grade corporate debt; investment grade municipal debt; investment grade structured financial products. Investors in these classes of fixed-income securities are not credit risk investors.

This means that there is only perhaps $1.5 trillion in deliberate credit risk investment in U.S. fixed-income markets: high-yield bonds plus junior tranches in structured financial products. There is another $1 trillion in speculative grade leveraged-loans. This indicates that the total pool of investors willing to assume real credit risk on any fixed-income security or the like in U.S. markets is around $2.5 trillion.

The limited pool of investment for real credit risk in fixed-income securities suggests that PLS cannot support anything close to the $11 trillion U.S. housing finance market, even with tranched credit risk. Assuming—perhaps generously—that PLS could be tranched so that there was no real credit risk for 90 percent of investors, the market would still require $1.1 trillion in credit risk investment. It is hard to see that emerging given that most of the $2.5 trillion in credit risk investment is already committed to the high-yield loan and bond markets, with only a small part invested in PLS (around $100 billion outstanding now in junior tranches) and other asset-backed securities.

Q.2. How can variable or flexible LTV ratios (or other methods) improve countercyclicality in the PLS market? What can be drawn from methods used in other countries, e.g., Spain or Canada?

A.2. In theory, authorizing a macroprudential regulator, such as the Federal Reserve Board or the Federal Open Markets Committee to impose maximum LTV ratios would provide a tool for countercyclical regulation that is focused solely on the housing market, as opposed to macroeconomic tools such as interest rates that affect more than the housing market. Such a tool would, of course, only be as useful as a regulator's willingness to use it.

Q.3. What are the risks of the different types of capital that could support bond guarantors, in particular, if capital was not limited to common equity? What is the most realistic mix of capital for guarantor entities taking first loss risk, or who should determine this and how should it be enforced?

A.3. If capital in bond guarantors was not limited to common equity, there is a risk that bond guarantors could have an asset-liability duration mismatch: their funding might be of shorter duration than the bonds they guarantee, resulting in the bond guarantors facing a risk of frozen capital markets or runs. To put this in the most extreme example, a bond guarantor that finances its operations through overnight repo could find itself without funding the next day, making its guarantees worthless.

I do not have an opinion on what is the most realistic mix of capital for guarantors entities taking first loss risk, but it is important that the capital requirements for bond guarantors not result in an arbitrage situation in which bond guarantors can hold less capital than competing methods of financing mortgages, such as depositories on balance-sheet operations. In general, any reform of the housing finance market should take care that there are similar capital requirements for all financing channels; if there is not, financing will flow to the channel with the lowest capitalization requirements, resulting in a less stable housing finance system.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR KIRK FROM ADAM J. LEVITIN

Q.1. FHFA has taken several steps while Fannie Mae and Freddie Mac have been in conservatorship to preserve the assets and protect the taxpayers. These steps include enhancing the underwriting, credit risk pricing, and reps and warrants contracts of counterparties with Fannie Mae and Freddie Mac. These actions ensure standards being used by the two Enterprises are more updated, comprehensive, transparent, and that they more accurately reflect the risks assumed by the two Enterprises. Had these reforms been implemented prefinancial crisis much of the fraud, poor risk-management, and losses to the taxpayers could have been avoided. Going forward, these actions are providing for a more attractive and transparent agency market for investors, which is essential to ensuring the U.S. housing market continues to be attractive for global investment.

Can you tell me if the private label security (PLS) market is adopting the same stringent transparency and contractual standards as the agency market? If not, why not?

A.1. The PLS market is not adopting the same stringent transparency and contractual standards as the agency market. As an initial matter, the PLS market has been moribund since 2008, with less than 40 PLS securitizations done since then. This makes it hard to meaningfully talk about the PLS market adopting any particular standards. The post-2008 PLS deals have had pristine, ultra-prime credit quality, but representations and warranties and structures for their enforcement vary considerably among post-2008 PLS deals. The PLS market appears to be experimenting with deal structures as it attempts to figure out what structures will strike the right balance between investor protection and seller/sponsor comfort.

Q.2. What is holding back standardization of the PLS market? What is happening to PLS pools in the market today?

A.2. There are no formal legal barriers to standardization of the PLS market. Instead, PLS continue to be nonstandardized because deal sponsors see no immediate benefit from standardizing. While standardizing PLS would help create a more robust and liquid market overall, currently there are only a small number of deals and the market is still trying to determine the optimal post-2008 deal structure.

Q.3. I would love to see the conforming loan limits for agency mortgage backed securities to be lowered, as it is one of the more obvious ways to increase and incentivize the private market back into this market space. I am concerned however that if the standards in the PLS market are not the same as the agency market—including to provide for clear and updated reps and warranties agreements and greater transparency—that investors will be hesitant to move to the PLS space.

If the standards for risk-based pricing, reps and warranties and standardization of agency securities are improved for any "agency-like" security that is developed post-housing finance reform, will investors begin demanding these enhanced standards for PLS investment? What more could be done to incentivize the private market to adopt such standards?

A.3. It is possible that reforms of the "agency-like" market will begin to set standards for PLS as well; this is something that can be observed elsewhere in fixed-income securities as many securities that are not subject to the Trust Indenture Act, such as sovereign bonds, nonetheless include deal terms required by the Trust Indenture Act. The PLS market could be incentivized to adopt such standards through the provision of regulatory safe harbors. I would nonetheless urge Congress to consider certain nonwaiveable minimum standards for PLS, akin to those required by the Trust Indenture Act of 1939 provides for covered debt securities.

Q.4. Do you think that the PLS market can truly be optimized if loan limits are lowered before greater transparency, contractual, and fiduciary changes/updates are adopted in the PLS market?

A.4. If conforming loan limits are lowered at this point, it is unlikely that the PLS market will expand rapidly to provide financing for homeowners with mortgage loans larger than the conforming loan limit. Instead, credit availability will likely significantly contract for these homeowners. Until and unless investors feel comfortable with PLS deal structures and have confidence that representations and warranties about the securitized loans will be enforced, I do not see the PLS market providing any meaningful level of financing for the U.S. housing market. Thus, I do not see lowering the conforming loan limits as precluding reforms in the PLS market so much as producing a decline in housing prices.